

Input methodologies review – related party transactions

Final decision and determinations guidance

Date of publication: 21 December 2017

Associated documents

Publication date	Reference	Title
21 December 2017	NZCC 30	Electricity Distribution Services Input Methodologies Amendments Determination 2017
21 December 2017	NZCC 31	Gas Distribution Services Input Methodologies Amendments Determination 2017
21 December 2017	NZCC 32	Gas Transmission Services Input Methodologies Amendments Determination 2017
21 December 2017	NZCC 33	Electricity Distribution Information Disclosure Amendments Determination 2017
21 December 2017	NZCC 34	Gas Distribution Information Disclosure Amendments Determination (No.2) 2017
21 December 2017	NZCC 35	Gas Transmission Information Disclosure Amendments Determination (No.2) 2017
12 April 2017	978-1-869455-64-4	Input methodologies review – Related party transactions – Invitation to contribute to problem definition
14 September 2016	978-1-869455-36-1	Input methodologies review: Process update paper
14 September 2016	Notice of intention	Amended notice of intention: Input methodologies review
20 December 2016	978-1-869455-44-6	Input methodologies review decisions: Introduction and process paper
20 December 2016	978-1-869455-53-8	Input methodologies review decisions: Framework for the IM review
20 December 2016	978-1-869455-51-4	Input methodologies review decisions: Report on the IM review
16 June 2016	978-1-869455-17-0	Input methodologies review draft decisions: Topic paper 7 – Related party transactions
1 October 2012	978-7-869452-09-4	Information Disclosure for Electricity Distribution Businesses and Gas Pipeline Businesses: Final Reasons Paper
16 January 2012	978-1-869451-87-5	Information Disclosure Requirements for Electricity Distribution Businesses and Gas Pipeline Businesses Draft Reasons Paper
22 December 2010	978-1-869451-32-5	Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper

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Executive Summary

What this paper covers

- X1 This paper sets out our final decision on our review of the related party transactions provisions as part of the input methodologies (**IMs**) review which was largely completed in December 2016.¹ The IMs are the core rules we set when we regulate services in the electricity distribution and gas distribution and transmission sectors.
- X2 We have made changes to the IMs and have also decided to change the information disclosure (**ID**) requirements for related party transactions to match these changes.
- X3 Related party transactions occur when a supplier of services that we regulate, such as an electricity lines business or a gas pipeline business, deals with an entity which is related to it by a common shareholding or other common control.²
- X4 We are concerned that consumers should not as a result of the related party relationship be harmed by having to pay higher prices for the regulated service. For example:
- X4.1 Under the current rules, regulated electricity and gas businesses are able to choose whether to competitively tender work out. As a result, regulated businesses may be incentivised to give work, such as network maintenance or tree trimming, to their unregulated related parties, even if an independent contractor could offer a better price or service.
- X4.2 Related party transactions could end up increasing the prices paid by consumers for regulated services, as the use of an unregulated related party to provide services may lead to higher input costs than if an independent supplier had provided those services.

¹ In September 2016 we decided to progress the review of the related party transactions provisions on a longer timeframe than the rest of the IM review. This was to allow more time to assess whether the issues identified in our June 2016 related party transactions topic paper amounted to a broader problem with the related party transactions provisions. On 20 December 2016 we published our final decisions on all other areas of the IM review except for three areas where we had not yet reached decisions. One of those areas was the related party transactions provisions, which is the focus of this paper.

² In this paper we refer to the supplier of a regulated service as the 'regulated supplier'. However, using that label does not preclude the supplier from also making unregulated supplies as well. This is demonstrated in the examples in this paper.

- X4.3 Related party transactions and the lack of information on what the equivalent arm's-length terms would have been can make it difficult to determine if cost efficiencies are being created in the regulated service, and whether those benefits are being shared with consumers of the regulated service or are just being enjoyed by the related party.
- X4.4 Related party transactions may harm consumers of the regulated service if the commercial relationship means quality is traded off in favour of other interests of the related party supplying the service, or if the regulated supplier uses a more costly input to deliver the regulated service without any corresponding increase in quality.
- X4.5 There can be less pressure from the commercial relationship to be innovative, which can lead to higher costs or lower quality of service for consumers.
- X4.6 If the regulated supplier has the ability to require its consumers to use its related party for services that are complementary to the regulated service, consumers may end up paying more than efficient prices for those services compared with if they were free to choose the supplier of the unregulated service. In our view, providing greater transparency through ID in relation to such requirements where they involve related parties of the regulated supplier will promote the long-term benefit of consumers of regulated services.
- X5 We are not looking to prevent regulated suppliers from using related parties to provide services, as they can be efficient, giving economies of scale and scope. But there is an onus on a regulated supplier to show that the cost of the underlying service is consistent with the input price that it would have otherwise paid in a transaction on arm's-length terms.
- X6 In this paper we set out:
- X6.1 our final decision on the review of the related party transaction provisions for Electricity Distribution Businesses (**EDBs**) and Gas Pipeline Businesses (**GPBs**); and
- X6.2 our guidance to those regulated suppliers to help them apply the changes to the IMs and ID determinations set out in the final decision.

X7 As this work is part of our 2016 IM review, we have applied our IM review framework in our decision-making.³

Our final decision

Principles-based valuation approach

X8 Our final decision removes the original prescriptive valuation options for disclosing the value of related party transactions. We concluded that those were not working well.

Principles-based approach introduced

X9 We have introduced instead a principles-based approach where regulated suppliers will need to show when dealing with a related party that the value of purchases and sales is disclosed so that:

X9.1 each purchase is valued at no more than if it had the terms of an independent arm's-length transaction;

X9.2 a sale or supply to a related party is valued at no less than if it had the terms of an arm's-length transaction; and

X9.3 the value of any transaction is based on an objective and independent measure.

X10 Consistent with the principles-based approach and to achieve a closer connection with the accounting and auditing standards which are familiar to regulated suppliers, we have adopted the wording for 'arm's-length transaction' from the definition in auditing standard ISA (NZ) 550.⁴

Testing of competitive markets and benchmarking of transaction values

X11 To meet the 'objective and independent measure' test, regulated suppliers will need to disclose how they test competitive markets to value transactions for IM and ID purposes, and be seen to apply that approach in practice.

³ Commerce Commission "Input methodologies review decisions: Framework for the IM review" (20 December 2016).

⁴ External Reporting Board (XRB) "International standard on auditing (New Zealand) 550 - Related Parties (ISA (NZ) 550)." Compiled November 2016 and incorporating amendments up to and including October 2016, page 9.

- X12 We decided to keep one of the original valuation options because it could be more cost effective for suppliers, while still meeting our policy objective. Suppliers will be able to use a consolidation (or cost-based) approach as a ‘safe-harbour’ for demonstrating compliance with the above general valuation principle.

Where you can read more about the valuation approach

- X13 Our decision on the general valuation approach is explained in Chapter 4 of this paper.

New disclosure requirements to support the valuation approach

An updated role for the independent auditors

- X14 Our decision to use general principles means there will be a closer connection to the accounting and auditing standards applied by the auditors who will in future need to give their opinion on the new valuation and disclosure requirements.
- X15 The auditor’s annual ID assurance report will be required to state whether in the auditor’s opinion the valuation and disclosure of related party transactions each year, in all material respects, shows that it complies with the general related party transactions valuation rule.

Our updated disclosure requirements

- X16 We have included new disclosure requirements if a supplier of the regulated service transacts with a related party in a disclosure year, including:
- X16.1 disclosure of related party relationships;
 - X16.2 disclosure of the regulated supplier’s procurement policies and processes in respect of a related party relationship;
 - X16.3 disclosure of policies which require or have the effect of requiring a consumer to purchase unregulated services from a related party that is related to the regulated service;
 - X16.4 details of how and when the regulated supplier last tested the market valuation of transactions in at least one expenditure category; and
 - X16.5 a map of anticipated network expenditure and network constraints likely to involve expenditure by the regulated supplier with related parties.

Reduced disclosure requirements in some cases to make the cost and effort proportionate

- X17 We have introduced a 'de minimis' threshold that limits the need for disclosure requirements where suppliers have lower levels of total expenditure or a minimal proportion of related party transactions. We think this will ensure that compliance costs are proportionate to the size of the supplier and its level of related party transactions.
- X18 The 'de minimis' thresholds for limited disclosures apply where a supplier has:
- X18.1 total annual expenditure of \$20 million or less; or
 - X18.2 under 10% of total annual expenditure made up of related party transactions.

More detailed reporting in other cases

- X19 The supplier of the regulated service will be required to seek a further more detailed report from the independent auditor or another qualified independent expert if:
- X19.1 the related party transactions are 65% or more of a year's total operating expenditure (**opex**) or capital expenditure (**capex**) spend; or
 - X19.2 the independent auditor is not able to conclude that the valuation or disclosures of related party transactions complies with the related party rules.
- X20 That regulated supplier will be required to obtain and disclose this independent report in any year if:
- X20.1 there was no report published for one of the immediately prior two years; and
 - X20.2 the total value of related party transactions in each of the opex or capex categories has increased by more than 5% for any year since the year looked at in the last report.

Where you can read more about the new disclosure requirements

- X21 Our decision on the new disclosure requirements is explained in Chapter 5 of this paper.

Our consultation with interested persons

- X22 We have had constructive engagement with a broad range of interested persons over the course of our decision making. We appreciate the time and effort all parties have taken to provide us with their submissions.

- X23 In particular, we received 18 submissions and 10 cross-submissions on our draft decision which we published in August 2017. The key topics raised in those submissions included:
- X23.1 support for the principles-based approach;
 - X23.2 ambiguity around paragraph (b) of the 'related party' definition;
 - X23.3 the suggestion for the 'de minimis' threshold in response to concerns of disproportionate compliance costs; and
 - X23.4 the suggestion to retain the consolidation (or cost-based) approach to valuation.
- X24 Our final decision is generally consistent with our draft decision. In response to the submissions, we made the following key changes to our draft decision:
- X24.1 We retained from the original requirements set in 2012 the consolidation (or cost-based) approach to valuation. We had not included this in our draft decision.
 - X24.2 We reduced the prescriptiveness of the disclosure requirements in the ID determination to reduce unnecessary compliance costs.
 - X24.3 We introduced the 'de minimis' threshold to allow regulated suppliers with small absolute or relative levels of related party expenditure to have less onerous disclosure requirements.
- X25 We also considered the suggestion proposed in submissions to take out part of the definition of 'related party' to line it up more closely with the related party definition in the accounting standards. However, we decided to keep paragraph (b) of the definition, as we consider that its removal would have left a gap in the regime in respect of unregulated services and would have put at risk the policy intent of the related party rules.

Chapter 1 Introduction

Purpose of this paper

- 1.1 This paper provides:
- 1.1.1 an outline of our policy intent for the related party transactions provisions (Chapter 2);
 - 1.1.2 confirmation of our problem definition for the input methodologies (**IMs**) and information disclosure (**ID**) (Chapter 3);
 - 1.1.3 an overview of our amendments to the related party transactions valuation methodology and changes to key definitions (Chapter 4);
 - 1.1.4 an outline of our amendments to the disclosure requirements for electricity distribution businesses (**EDBs**), gas distribution businesses (**GDBs**) and the gas transmission business (**GTB**) (Chapter 5);
 - 1.1.5 guidance on the interpretation of the two paragraphs of the 'related party' definition (Attachment A);
 - 1.1.6 indicative examples of transactions on arm's-length and non-arm's-length terms (Attachment B);
 - 1.1.7 an outline of the relationship between the cost allocation provisions and related party transactions provisions (Attachment C); and
 - 1.1.8 how we have incorporated elements of the auditing and accounting standards into the determinations by reference (Attachment D).

How this paper fits into the IM review and with ID amendments

- 1.2 We first put the related party transactions provisions in place in 2010 for the IMs and 2012 for ID provisions. We have now reviewed these as part of our IM review process which commenced in mid-2015. The related ID requirements for related party transactions were first determined in 2012.

- 1.3 In June 2016 we published a related party transaction topic paper as part of our draft decisions package for the IM review. We set out why we considered it useful for our review to simultaneously consider with the IMs whether changes to the associated related party transactions ID requirements were required.⁵
- 1.4 In September 2016 we decided to progress the review of the related party transactions provisions on a longer timeframe than the rest of the IM review.⁶ This was to allow more time to assess whether the issues identified in our June 2016 related party transactions topic paper amounted to a broader problem with the related party transactions provisions.⁷
- 1.5 On 20 December 2016 we published our final decisions on all areas of the IM review except for the three areas where we had not yet reached decisions. One of those areas was the related party transactions provisions, which is now the focus of this paper.⁸ As this work remains part of the IM review, we have applied our IM review framework for decision making.⁹
- 1.6 In early 2017 we met with a broad selection of regulated suppliers and representatives of various auditing firms providing assurance reports in the regulated sectors. The purpose of these meetings was to assess the extent to which the related party transactions regime meets the policy intent of the related party provisions and to gain a better understanding of a range of practical matters relevant to the regime.

⁵ We note any changes to the ID requirements are consulted on and made under s 52Q of the Act, rather than under s 52Y. Our topic paper indicated that we would review our related party provisions across ID and the IMs in parallel. See Commerce Commission “Input methodologies review draft decisions: Topic paper 7 – Related party transactions” (16 June 2016).

⁶ Commerce Commission “Input methodologies review: Process update paper” (14 September 2016); Commerce Commission “Amended notice of intention: Input methodologies review” (14 September 2016).

⁷ Commerce Commission “Input methodologies review draft decisions: Topic paper 7 – Related party transactions” (16 June 2016).

⁸ Our final IM review decisions can be found in: Commerce Commission “Input methodologies review decisions: Summary paper” (20 December 2016). We have since reached our decision on the Transpower Incremental Rolling Incentive Scheme (**IRIS**) as part of the Transpower IM. We are yet to reach a decision on our review of the IMs relating to CPP information requirements for gas. See: Commerce Commission “Input methodologies review decisions: Introduction and process paper” (20 December 2016).

⁹ Commerce Commission “Input methodologies review decisions: Framework for the IM review” (20 December 2016).

- 1.7 In April 2017 we published our problem definition paper which presented our initial findings and emerging views on the problems with the original related party transactions IMs and ID provisions. We sought submissions on this paper which informed our draft decisions. Chapters 2 and 3 of this paper are based on the problem definition paper and updated where appropriate in response to those submissions.
- 1.8 On 30 August 2017 we published our draft decision paper. We received a large number of substantive submissions and cross-submissions on the paper, including a specific audit submission from PwC. We additionally took the opportunity to discuss concepts and drafting with the Office of the Auditor General (**OAG**) as the appointer of a number of auditors in the EDB sector. We considered these views in coming to our final decisions presented in this paper.
- 1.9 This paper provides the reasons for our IM and ID decisions, and provides guidance to support your use of the IM and ID amendments determinations.¹⁰

Our published documents

- 1.10 Our EDB, GDB and GTB ID determinations also include amendments made as part of a separate project which has been published on the same date.¹¹

Who this paper will be relevant to

- 1.11 The related party transactions provisions discussed in this paper apply to EDBs, GDBs and the First Gas GTB.
- 1.12 This paper may also be of interest to:
- 1.12.1 entities involved in (or planning to be involved in) related party transactions with EDBs, GDBs, or the GTB;
 - 1.12.2 entities other than related parties that are involved in (or planning to be involved in) transactions to provide services or assets to EDBs, GDBs, or the GTB;
 - 1.12.3 auditors completing compliance engagements on annual ID requirements of the regulated suppliers;

¹⁰ To help you navigate from the requirements in the determinations to the reasons and explanatory material in this paper, we have inserted guidance notes into the determinations for key amended clauses and definitions, which we expect to stay in the final determinations.

¹¹ These changes are described in: Commerce Commission “Amendments to information disclosure determinations for airport services, electricity distribution services, and gas pipeline services: Companion paper” (21 December 2017).

1.12.4 other gas and electricity sector firms, such as generator-retailers; and

1.12.5 consumers of electricity lines services and gas pipeline services.

Effective dates

Price-quality paths

1.13 The IM amendments take effect from the date of publication in the *NZ Gazette* (ie, from 22 December 2017). This means:

1.13.1 the IM amendments apply to any customised price-quality path (**CPP**) proposal submitted to us from 22 December 2017; and

1.13.2 the IM amendments will apply to default price-quality paths (**DPPs**) when they are next reset in 2020 and 2022.¹²

Information disclosure

1.14 The IM and ID amendments take effect for ID disclosure years that commence after the amendments are published. The EDB disclosure year 2019 commences on 1 April 2018. The GDB disclosure year 2019 commences on 1 June 2018 or 1 October 2018 depending on the GDB. The GTB disclosure year 2019 commences on 1 October 2018.

1.15 In particular, the EDB IM and ID amendments will apply to disclosed information that we may use in determining the EDB 2020 DPP reset. Our objective is to ensure that at least one year of updated disclosures is available to us for reference in determining that reset.

1.16 Some submissions on our draft decision suggested a phased implementation for the application of the new related party rules.¹³ Our final decision is to not change the implementation timeframe outlined in our draft decision. We consider that the simplification of the related party rules in our final decision removes the need for delayed implementation of the rules.

¹² The next EDB DPP reset is scheduled to take effect from 1 April 2020 and the GDB and GTB 2022 DPP resets are scheduled to take effect from 1 October 2022.

¹³ For example, Aurora Energy “Submission: Related party transactions: Draft decision and determinations guidance” (27 September), page 4.

Education on our related party rules

- 1.17 We intend to hold EDB ID workshop sessions with EDBs and auditors in April 2018 to assist those in the EDB regulation teams and their auditors to plan for the new disclosures, depending on the level of disclosures required under our new requirements.¹⁴
- 1.18 We intend to engage directly with First Gas and other GDBs on the implementation of the new rules in April 2018 (for the 2018-2019 disclosures).
- 1.19 We consider that April 2018 is timely for the education sessions as this is the time from which the new rules will apply to EDBs. We consider that the sessions will:
- 1.19.1 help regulated suppliers prepare for what information they need to collect under our new requirements; and
 - 1.19.2 explain our expectations of auditors for their opinions on regulated suppliers' compliance with our new requirements.
- 1.20 We will be in contact in early 2018 inviting participation in the workshops. We expect to review the first round of disclosures in late 2019 or early 2020.

¹⁴ The different levels of disclosures are described in Chapter 5 of this paper.

Chapter 2 Related party transactions policy intent

Purpose of this chapter

- 2.1 This chapter describes:
 - 2.1.1 the focus of this review;
 - 2.1.2 the background on the related party transactions provisions;
 - 2.1.3 the policy intent of the provisions;
 - 2.1.4 how we used the IM review framework to review the policy intent of the provisions; and
 - 2.1.5 our view that the policy intent remains relevant.

The focus of this review

- 2.2 Related party transactions occur when a regulated supplier transacts with an entity which is related to it by a common shareholding or other common control. Those transactions may not be on arm's-length terms and the input costs of the regulated supplier may not reflect efficient costs that we would expect might otherwise apply in the absence of such a relationship.¹⁵
- 2.3 In this review we are interested in transactions where parties related to the regulated supplier, or unregulated parts of the regulated supplier, are providing inputs to the regulated supplier. The total volume and value of related party transactions are proportionately large for regulated services (ie, electricity lines services and gas pipeline services) and appear to be growing.¹⁶
- 2.4 The presence of related party transactions may not promote the Part 4 purpose. Our concern is that suppliers of regulated services have the ability to use a related party to:
 - 2.4.1 increase overall profits by overcharging for inputs supplied by the related party; and/or

¹⁵ In referring to 'input costs', we are referring to capex and/or opex costs to the regulated supplier.

¹⁶ The scale of related party transactions across EDB opex and capex can be seen in Figures 3.2 to 3.4 of Commerce Commission "Related party transactions – Invitation to contribute to problem definition" (12 April 2017). For the most recent disclosure data (year to 31 March 2017), refer to our performance summaries for electricity distributors published on the Commission's website: <http://www.comcom.govt.nz/dmsdocument/15808>.

- 2.4.2 purchase services from a related party when it is not the most efficient supplier.
- 2.5 We are concerned with ensuring that consumers of the regulated service should not be harmed by having to pay higher prices for the regulated service as a result of either of these two causes.
- 2.6 There may be an incentive for the regulated supplier to use an unregulated related party to supply inputs at increased prices (and higher overall profits to the group).
- 2.7 Also, we are concerned that a supplier of a regulated service may be incentivised to use a related party for an input to the regulated service even though it may not be the most efficient provider of the input. Further detail of the potential risks of related party transactions in achieving our regulatory objectives are outlined in Table 2.1.
- 2.8 Although our related party provisions cover sales from the regulated supplier to the related party, we consider these transactions are much less common and are less material than the opex and capex inputs from the related party to the regulated supplier, and are not a major focus area of our review.¹⁷
- 2.9 If a regulated supplier sells assets, goods or services to a related party at prices below arm's-length, consumers of the regulated service will essentially be subsidising supply to the related party.¹⁸ This can increase profits to the related party through charging consumers of the regulated service.
- 2.10 For completeness, these sales provisions have been considered as part of our review.

Our related party transactions provisions

- 2.11 We regulate related party transactions through both our IM and our ID rules. Part 2 of each of the sector IM determinations applies related party transaction rules to capex which is included in the value of commissioned assets that enters the regulatory asset base (**RAB**) for the purposes of both ID and price-quality paths.¹⁹

¹⁷ In the 2016 disclosures, sales total \$2 million across all EDBs, which is less than 1% of total regulatory income.

¹⁸ The related party will be procuring these services from the regulated supplier at a lower cost than we would expect from a transaction between two independent parties acting in their own best interests.

¹⁹ *Electricity Distribution Services Input Methodologies Amendments Determination 2017* [2017] NZCC 30, clause 2.2.11(1)(g); *Gas Distribution Services Input Methodologies Amendments Determination 2017* [2017] NZCC 31, clause 2.2.11(1)(g); and *Gas Transmission Services Input Methodologies Amendments*

- 2.12 The ID determinations draw on the IM valuation rule for commissioned assets and include valuation rules that cover the cost of services provided to a regulated service by a related party. They also include valuation rules for the sale or supply of an asset or good or service to a related party.²⁰
- 2.13 The ID determinations include a requirement to provide a report on related party transactions (ie, in respect of both capex and opex).²¹
- 2.14 Although we value opex under the ID provisions, we also take these values into account in forming our conclusions on the opex allowances we use when setting a price-quality path.
- 2.15 The common types of transactions covered by the related party provisions are:
- 2.15.1 IMs:²²
- 2.15.1.1 the valuation of assets acquired from a related party.
- 2.15.2 ID:²³
- 2.15.2.1 the valuation of services (all opex) acquired from a related party; and

Determination 2017 [2017] NZCC 32, clause 2.2.11(1)(g). These provisions are set out in accordance with s 52T(1)(a)(ii) of the Act.

²⁰ *Electricity Distribution Information Disclosure Amendments Determination 2017* [2017] NZCC 33, clause 2.3.6; *Gas Distribution Information Disclosure Amendments Determination (No.2) 2017* [2017] NZCC 34, clause 2.3.6; and *Gas Transmission Information Disclosure Amendments Determination (No.2) 2017* [2017] NZCC 35, clause 2.3.6.

²¹ *Electricity Distribution Information Disclosure Amendments Determination 2017* [2017] NZCC 33, clause 2.3.1 and Schedule 5b; *Gas Distribution Information Disclosure Amendments Determination (No.2) 2017* [2017] NZCC 34, clause 2.3.1 and Schedule 5b; and *Gas Transmission Information Disclosure Amendments Determination (No.2) 2017* [2017] NZCC 35, clause 2.3.1 and Schedule 5b. These provisions are set out in accordance with s 53C(2)(e) and (k) and s 53D of the Act.

²² The related party capex transaction valuation methodology is provided in *Electricity Distribution Services Input Methodologies Amendments Determination 2017* [2017] NZCC 30, clause 2.2.11(5); *Gas Distribution Services Input Methodologies Amendments Determination 2017* [2017] NZCC 31, clause 2.2.11(5); and *Gas Transmission Services Input Methodologies Amendments Determination 2017* [2017] NZCC 32, clause 2.2.11(5).

²³ The related party opex and sales valuation methodology for EDBs is provided in *Electricity Distribution Information Disclosure Amendments Determination 2017* [2017] NZCC 33, clause 2.3.6; *Gas Distribution Information Disclosure Amendments Determination (No.2) 2017* [2017] NZCC 34, clause 2.3.6; and *Gas Transmission Information Disclosure Amendments Determination (No.2) 2017* [2017] NZCC 35, clause 2.3.6.

2.15.2.2 the valuation of sales to (and revenue received from) a related party.

- 2.16 Our related party provisions provide valuation methodologies that are intended to ensure transactions between a related party and a supplier of regulated services are recognised for regulatory purposes at values that are equivalent to arm’s-length terms.
- 2.17 These provisions consider the valuation and disclosure of opex or capex inputs from a related party to the supplier of the regulated service, and sales to a related party by the supplier of the regulated service.
- 2.18 As a practical matter, we are not permitted to integrate all of the valuation requirements into the IMs, as there is no existing opex input methodology. We cannot create an IM on a matter not covered by an existing IM under s 52Y or s 52X of the Act, which is why we do not have an IM for opex and cannot now determine one.
- 2.19 The IMs set out the rules for the valuation of assets and capex, and our rules for the valuation of opex and sales transactions are set out in the ID requirements.²⁴

Why we regulate related party transactions

2.20 The purpose of Part 4 of the Act is outlined as:²⁵

The purpose of this Part is to promote the long-term benefit of consumers in markets by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services—

(a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and

(b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and

(c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and

(d) are limited in their ability to extract excessive profits.

²⁴ See Commerce Commission “Input methodologies review decisions: Framework for the IM review” (20 December 2016), para 47.

²⁵ As set out in s 52A of the Act.

Potential outcomes and risks of related party transactions with respect to the Part 4 purpose

- 2.21 We consider that transactions between related parties have the potential to impact the achievement of the Part 4 purpose.²⁶
- 2.22 Table 2.1 sets out the relevant regulatory objectives under Part 4 and considers the outcomes and risks that related party transactions can have for the achievement of these objectives.²⁷
- 2.23 When suppliers are selling their goods or services in competitive markets, the price they charge reflects the interplay between demand and supply from a range of other parties. In this context, a consumer does not typically care what costs the supplier incurs and why, nor do they care whether the supplier has used related party relationships to produce its service.
- 2.24 This is because the consumer has choices over what to buy and from whom, and can switch products or suppliers if they find a better offer. One supplier attempting to pass on costs specific to it (not borne to the same extent by other suppliers) can expect to lose market share, and potentially profits, as consumers may prefer other suppliers' offers.
- 2.25 In contrast, a supplier of a regulated service has market power and, in the absence of regulation, would charge a price that reflects that market power. The regulatory price for their services is determined largely by the costs they incur.
- 2.26 For example, as a starting point under our price-quality regulation we assume the costs that regulated suppliers incur reflect efficient costs, and we use estimates of actual and forecast costs to inform allowed prices. Exempt suppliers may also use their actual or budgeted costs to determine prices for their services.
- 2.27 When referring to efficient costs we mean the prudent costs that a supplier of the regulated service would require to meet or manage expected demand for its services, at appropriate service standards.
- 2.28 In the regulated context, we and consumers therefore care about whether the underlying costs incurred in setting prices are efficient, and in particular whether the cost paid for a service from a related party is efficient, because it may directly impact on the price that consumers ultimately pay.

²⁶ As set out in s 52(a)(1(a)–(d)) of the Act.

²⁷ We also consider the s 53A ID purpose in our review of the related party provisions further on in this chapter.

- 2.29 We do not seek to prevent regulated suppliers from using related parties to provide services as they can be efficient, securing economies of scale and scope. However, there is an onus on the regulated supplier to be able to demonstrate that the cost of the underlying service is efficient and consistent with the input price that it would have paid in an arm's-length transaction.

Table 2.1 Risks to regulatory objectives posed by related party transactions

Regulatory objective	Intended outcome	Potential risks of related party transactions
Efficiency ²⁸	Suppliers of regulated services should have incentives to improve efficiency in the supply of the regulated goods or services and share the benefits of efficiency gains with consumers through lower prices.	<p>Close business relationships (including related party relationships) may generate economies of scale and scope that could benefit consumers. However, the presence of related party transactions, coupled with the lack of information on what equivalent arm's-length terms would have been, can make it hard to determine:</p> <ul style="list-style-type: none"> • if cost efficiencies (or inefficiencies) are being created; and • whether any efficiencies are being shared with consumers of the regulated service; or • whether a related party has chosen the most efficient supplier and hence whether any inefficiencies are affecting input costs. <p>Our related party transactions provisions seek to ensure such efficiencies are shared with consumers.</p>

²⁸ When referring to efficiency of related party transactions, we are referring to cost efficiencies in providing services at a quality that reflects consumer demands and the sharing with consumers of the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices: see s 52A of the Act.

Regulatory objective	Intended outcome	Potential risks of related party transactions
Profits	Suppliers of regulated services should expect profits are just sufficient to reward investment, efficiency and innovation. Superior performers are more likely to be rewarded by receiving returns greater than a 'normal profit' (or 'normal return' - ie, their risk-adjusted cost of capital), at least for the short-to-medium term, until competitors catch up. Over the lifetime of its assets, a typically efficient supplier would not invest unless it expected, in advance, to earn at least a normal return.	Due to the close business relationship between related parties, there is the potential to increase overall profits by overcharging for inputs supplied by the related party. This could adversely affect the consumer of the regulated service through higher prices, which is a key consideration in our review.
Price	The price paid by consumers should be based on efficient input costs. In workably competitive markets, suppliers have incentives to constrain price.	The presence of related party transactions may adversely affect the ability to constrain prices to the benefit of consumers, as there may be an ability to use an unregulated related party to increase overall profits. This is a key consideration in our review.
Quality	Suppliers of regulated services should have incentives to improve efficiency and provide services at a quality that reflects consumer demands.	The presence of related party transactions may adversely affect quality of service provided to consumers of the regulated service if the relationship means quality is traded off in favour of other interests of the party supplying the service. This issue is not a primary driver of the related party provisions across the IM and ID determinations.
Investment	Suppliers of regulated services should have incentives to undertake investments at an efficient level at the optimal time (to the extent these levels and time can be ascertained).	The presence of a related party relationship and extensive related party transactions could affect the level and timing of investment. For example, if weight is placed on the interests of the related party supplying the service, more investment may be undertaken or more opex incurred, and at greater cost, than if the relationship and all transactions were on arm's-length terms.
Innovation	Suppliers of regulated services should have incentives to promote the discovery and use of new information, leading to the development of new goods and/or services, and more efficient production techniques.	Given related parties are not independent and have an ongoing close operating nature, there can be reduced pressure from the commercial relationship to be innovative.

Relationship between cost allocation and the related party transactions provisions

- 2.30 The cost allocation rules split shared costs between regulated and unregulated activities for regulatory purposes. For example, common operating costs (eg, expenses for a head office) and commonly used assets (eg, poles which carry both electricity and fibre) have their costs shared between regulated and unregulated services.²⁹
- 2.31 Sharing of services can produce cost efficiencies. A purpose of cost allocation is to ensure these efficiencies are effectively shared with consumers. The cost allocation provisions look at the splitting of shared costs between unregulated and regulated activities.
- 2.32 However, the cost allocation provisions do not address:
- 2.32.1 the value placed on services supplied by a related party; or
 - 2.32.2 the value of revenues from sales to a related party.
- 2.33 These are dealt with in the related party transactions provisions to ensure such transactions are valued on terms that are equivalent to arm's-length. For example, when considering an internal part supplying unregulated services within a regulated supplier. The related party rules assess the valuation of goods and services provided by the internal part or related separate legal entities.
- 2.34 We provide a diagram in Attachment C that shows how and when to value a transaction with a related party that has a cost allocation requirement.

²⁹ Cost allocation rules for ID are found in: *Electricity Distribution Services Input Methodologies Determination 2012 – (consolidated as of 28 February 2017)*, Part 2 Subpart 1; *Gas Distribution Services Input Methodologies Determination 2012 – (consolidated as of 28 February 2017)*, Part 2, Subpart 1; and *Gas Transmission Services Input Methodologies Determination 2012 – (consolidated as of 28 February 2017)*, Part 2, Subpart 1. Cost allocation rules for CPP proposals are found in: *Electricity Distribution Services Input Methodologies Determination 2012 – (consolidated as of 28 February 2017)*, Part 5, Subpart 3; *Gas Distribution Services Input Methodologies Determination 2012 – (consolidated as of 28 February 2017)*, Part 5, Subpart 3; and *Gas Transmission Services Input Methodologies Determination 2012 – (consolidated as of 28 February 2017)*, Part 5, Subpart 3.

Review of the policy intent of the related party transactions provisions

- 2.35 Consistent with the IM review framework, in reviewing the related party transactions provisions we considered whether the policy intent was still relevant, and whether the way the provisions have been implemented could be more effective in achieving that policy intent, or achieve it in a way that better promotes s 52R or reduces complexity and compliance costs.³⁰
- 2.36 In deciding whether to make changes to the provisions as a result of this review, we are guided by the IM review framework. Specifically, we only propose changing the related party transactions provisions across the IMs and ID where this appears likely to:
- 2.36.1 promote the Part 4 purpose in s 52A more effectively;
 - 2.36.2 promote the IM purpose in s 52R more effectively (without detrimentally affecting the promotion of the s 52A purpose); or
 - 2.36.3 significantly reduce compliance costs, other regulatory costs or complexity (without detrimentally affecting the promotion of the s 52A purpose).
- 2.37 We also considered the s 53A ID purpose to the extent we have considered changes to the ID requirements.³¹
- The purpose of information disclosure regulation is to ensure that sufficient information is readily available to interested persons to assess whether the purpose of this Part (Part 4) is being met.
- 2.38 We also considered, where relevant, whether there were alternative solutions to the identified problems with the IMs and ID that do not involve changing the IMs.

Whether the policy intent of the related party transactions provisions is still relevant

- 2.39 We have expressed the policy intent in various documents over time as summarised below. The words used in each instance are not exactly the same, but the key principles from our documents are.

³⁰ This is set out in more detail in: Commerce Commission “Input methodologies review decisions: Framework for the IM review” (20 December 2016).

³¹ See s 53A of the Act.

- 2.40 Our concern is that suppliers of regulated services have the ability to use an unregulated related party to:
- 2.40.1 increase overall profits to the overall group by overcharging for inputs supplied by the related party to the regulated service; and/or
 - 2.40.2 purchase services from a related party when it is not the most efficient supplier.
- 2.41 Inputs into the regulated service may in either of those cases end up being over-priced, which would not promote the long-term benefit of consumers.
- 2.42 Our policy intent is therefore to ensure that the value of a good or service acquired by the regulated supplier from a related party, or the value received from the sale or supply by the regulated supplier of an asset or good or service to a related party, is disclosed on the basis that:
- 2.42.1 each related party transaction is valued as if it had the terms of an arm's-length transaction; and
 - 2.42.2 the value of a related party transaction is based on an objective and independent measure.

What we said in 2010 in the development of the input methodologies

- 2.43 In our 2010 paper, the intention behind the development of our related party transaction provisions in the IMs was:³²

Without the discipline of arm's-length negotiation, which is essentially where the price paid for an asset may be greater (or less) than an asset's market value, there could be a transfer of value between an EDB or GPB and consumers that would not otherwise occur. To address this concern, the Commission considers that where a regulated supplier buys an asset from a related party, the asset's RAB value should not be based on the purchase price, but instead on some objective, independent measure.

What we said in 2012 when putting in place the information disclosure requirements

- 2.44 In our 2012 paper, our intention behind the related party transactions ID requirements was to enable interested persons to understand whether the information disclosed may be affected by related party dealings.

³² Commerce Commission "Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper" December 2010, E8.8–E8.9.

- 2.45 In setting ID requirements we considered the value placed on services supplied by related parties and revenues received from related parties. The policy intent in our ID determinations is similar to that of the IMs. ID also requires the value of related party transactions to be based on, or linked to, objective verifiable information. This information should help demonstrate that the price approximates that which could be expected in a transaction on arm's-length terms.³³
- 2.46 We concluded in 2012 that the related party transactions provisions in ID should allow interested persons to have access to information that discloses:
- 2.46.1 the existence and extent of related party transactions;
 - 2.46.2 what the related party transactions relate to;
 - 2.46.3 whether the price is the same or similar to the price which would be expected in an equivalent arm's-length transaction (and if not, what adjustment is required to make it similar to an arm's length price); and
 - 2.46.4 whether the price is based on objective verifiable information.

Continued policy relevance

- 2.47 We consider the policy intent of the related party transactions provisions is still relevant for both the IMs and ID. We have seen nothing in our review which suggests that the policy intent for these provisions should change.
- 2.48 Submissions on our problem definition paper generally agreed with our policy intent to ensure that transactions between related parties and suppliers of regulated services are equivalent to arm's-length terms.³⁴

³³ Commerce Commission "Information Disclosure Requirements for Electricity Distribution Businesses and Gas Pipeline Businesses Draft Reasons Paper" (16 January 2012), A1.36.

³⁴ For example, see Pioneer Energy "Pioneer Energy submission - Related party transactions - problem definition" (17 May 2017), page 1; and ENA "ENA Submission on IM review - Related party problem definition" (17 May 2017), page 4.

Chapter 3 The problem definition

Purpose of this chapter

- 3.1 This chapter provides:
- 3.1.1 our response to relevant submissions on the problem definition; and
 - 3.1.2 our confirmation of the problem definition.

The problems identified³⁵

- 3.2 We identified the following broad problem with the original related party provisions:³⁶
- 3.2.1 The practical application of the related party provisions was not well aligned with the policy intent.³⁷
- 3.3 This can be further broken down into two problems with a common linked potential harm to consumers of regulated services:
- 3.3.1 Aspects of the way we designed and implemented the related party transactions rules raises a risk that we would not achieve the related party transactions policy intent (problem one).
 - 3.3.2 Aspects of the way in which some regulated suppliers applied the rules also raised the risk that the related party transactions policy intent is not being achieved in practice (problem two).

³⁵ In April 2017 we published a problem definition paper outlining our initial findings and emerging views on related party transactions regime. See Commerce Commission “Related party transactions – Invitation to contribute to problem definition” (12 April 2017).

³⁶ *Electricity Distribution Services Input Methodologies Determination 2012 – (consolidated as of 28 February 2017); Gas Distribution Services Input Methodologies Determination 2012 – (consolidated as of 28 February 2017); Gas Transmission Services Input Methodologies Determination 2012 – (consolidated as of 28 February 2017); Electricity Distribution Information Disclosure Determination 2012 – (consolidated in 2015); Gas Distribution Information Disclosure Determination 2012 – (consolidated in 2015); and Gas Transmission Information Disclosure Determination 2012 – (consolidated in 2015)*. Throughout this paper we refer to these decisions as our ‘original’ decisions.

³⁷ Commerce Commission “Related party transactions – Invitation to contribute to problem definition” (12 April 2017), para 4.2.1.

- 3.4 We see our role as being to create rules that support regulated suppliers in meeting the arm's-length policy intent. Our related party transactions provisions are aimed at requiring regulated suppliers and their related parties to demonstrate that for regulatory purposes, the transactions between them are equivalent to arm's-length terms. To achieve this, our related party rules must be workable and applicable in a wide range of supplier circumstances.
- 3.5 We have outlined the above problems based on our discussions with a sample of EDBs and sector auditors, submissions received during the IM review, and information gathered through our reviews of ID over time.
- 3.6 As a result of the two identified problems, the value at which an asset or service is transferred from a related party to a regulated supplier may not be consistent with an arm's-length transaction. We wish to avoid this, as it could frustrate the achievement of the Part 4 purpose.³⁸

What we considered in reaching our view on the problem

- 3.7 In designing and implementing our original rules we provided a number of valuation and disclosure options which may not be achieving our intended outcomes. This is because we understand some of the prescriptive options we originally designed may not be usable in a number of typical company ownership and operating structures.
- 3.8 In understanding the two problems identified above, we have analysed the context and issues under the following headings:
- 3.8.1 imperfect local markets consideration;³⁹
 - 3.8.2 complexity and understanding of terminology;
 - 3.8.3 transparency of disclosures; and
 - 3.8.4 compliance with the prescribed rules.

³⁸ Chapter 2, Table 2.1 sets out the regulatory objectives consistent with Part 4 of the Act and considers the outcomes and risks that related party transactions can have on the achievement of these objectives.

³⁹ In smaller regional markets, EDBs may have fewer choices and face difficulties in attracting third party contracting service companies and some specialist services to the area to get the services required. We refer to this issue as imperfect local markets. An EDB example is not having electrical contracting services readily available in the EDB location.

- 3.9 Table 3.1 and Table 3.2 provide explanations of the problems and our view of their potential impact on consumers. These tables outline:
- 3.9.1 what we saw from our discussions with the sample of EDBs, auditors, and in the ID reporting, and how this points to the problems;⁴⁰
 - 3.9.2 the effect the focus areas outlined in these tables is having on the identified problems; and
 - 3.9.3 our consideration of the materiality of the issues for consumers.

⁴⁰ An overview of our initial findings can be found in Chapter 3 of our problem definition paper, see Commerce Commission “Related party transactions – Invitation to contribute to problem definition” (12 April 2017).

Table 3.1 Problem with the nature of our original design and implementation of the related party transactions provisions and potential impact on consumers

Overarching problem	Focus areas	What are we seeing which points to this being a problem?	Effect of the problem	Materiality of potential impact on consumers
Our design and implementation of the provisions	Imperfect local market for contracting services	<p>In our original decisions, we attempted to design a range of disclosure options that would encompass most foreseeable circumstances such as an imperfect local market for contracting services. Due to the lack of comparative market information, there is a difficulty in measuring an appropriate internal margin for contracting activities provided by an integrated business unit of the regulated supplier or another company in the group.</p> <p>In particular, the provisions provide options for disclosing using a competitive tender process, however only a small number of regulated suppliers disclose using this option.</p>	Valuation of transactions affected in each case. This could lead to transactions not being equivalent to arm's-length terms, which could adversely affect the consumer.	<p>Medium</p> <p>Not all regulated suppliers face an imperfect local market in assessing whether transactions are on the equivalent of arm's-length terms.</p>

Overarching problem	Focus areas	What are we seeing which points to this being a problem?	Effect of the problem	Materiality of potential impact on consumers
	Complexity of terminology	<p>Ambiguity is caused by:</p> <ul style="list-style-type: none"> • the original rules use some terms that are not as well defined as they could be; and • some terms used have more than one meaning within the IMs and more broadly. <p>In particular, the term ‘directly attributable costs’ is used in the cost allocation provisions to mean something different from the meaning intended for related party transactions. A ‘related party’ is defined in accounting standards but defined differently for the purposes of our regulatory rules.⁴¹</p>	Decreased quality of disclosure and potential impact on the valuation of transactions.	<p>High</p> <p>This could have a large impact on the valuing of transactions.</p>

⁴¹ In its submission, Vector noted that a clear definition about the term related party should mitigate the likelihood for selective interpretation. Vector “Vector submission on related party transactions” (17 May 2017), para 22.

Overarching problem	Focus areas	What are we seeing which points to this being a problem?	Effect of the problem	Materiality of potential impact on consumers
	<p>Transparency of our methodology</p>	<p>The way in which the original valuation options are drafted can lead to some regulated suppliers defaulting to the director certification option. This provides stakeholders with limited transparency of information to assessing whether the transactions are at the equivalent of arm's-length terms.</p> <p>A high proportion and value of transactions are being disclosed under this low visibility option. This raises questions as to the appropriateness of the methodology if directors are not applying the necessary rigour in providing certification.</p>	<p>Decreased confidence in ID. This makes it hard for us to assess whether any efficiencies are being shared with consumers of the regulated service if these are being enjoyed by the related party.</p>	<p>Medium</p> <p>Some disclosure valuation options result in limited transparency. We consider the percentage of EDBs using the director certification option is sufficiently material to limit transparency of the potential impact on consumers.</p>
	<p>Compliance with the prescribed rules</p>	<p>The original rules are drafted in a way which has led to some confusion as to which rules apply to opex and capex transactions due to the disconnection of the IMs and ID.⁴²</p> <p>In particular, ID shows some suppliers of regulated services inappropriately applying IM capex rules to opex or vice versa.</p>	<p>Decreased quality of disclosure. Any inconsistent disclosure decreases transparency that transactions are on arm's-length terms.</p>	<p>Low</p> <p>Some suppliers are showing confusion as to what ID and IMs cover.</p>

⁴² A number of submissions on the problem definition paper noted the problem with the inconsistency across the IMs and ID, including PwC. PwC "PwC group submission on related parties" (17 May 2017), page 10.

Table 3.2 Problem with the nature of regulated suppliers' application of the original related party transactions provisions and potential impact on consumers

Overarching problem	Focus areas	What are we seeing which points to this being a problem?	Effect of the problem	Materiality of potential impact on consumers
Regulated suppliers' application of the provisions	Imperfect local market in contracting services	<p>We are seeing limited separation of governance between management of the related party and the supplier of the regulated service. This, combined with a lack of credible benchmarking between the regulated supplier and its various related parties in imperfect local markets, means there is less likelihood that related party transactions will be demonstrated to be on the equivalent of arm's-length terms.⁴³</p> <p>In particular, some behaviour shows procurement preference for 'in-house' contracting services, which is also supported by a submission.⁴⁴</p>	Valuation of transactions may be affected. If the input prices paid by the regulated supplier are too high, this would not promote the long-term benefit of consumers of the regulated service.	<p>Medium</p> <p>This type of market is not faced by all regulated suppliers.</p>
	Complexity in understanding terminology	Due to the ambiguity of the key defined terms, suppliers have made their own interpretations as to the defining of key terms in the rules, such as directly attributable costs.	Valuation of transactions may be affected. This could lead to higher input costs for the regulated supplier, which would adversely affect the long-term benefit for consumers of the regulated service.	<p>High</p> <p>Due to potential impact on the valuation of transactions.</p>

⁴³ The ENA acknowledged that imperfect local markets are a characteristic of the sector, and that the Commission cannot solve this problem through related party transaction rules. ENA "ENA Submission on IM review - Related party problem definition" (17 May 2017), para 21. We agree that the related-party transaction rules cannot solve this problem, but it should be considered when assessing whether related party transactions meet arm's-length terms.

⁴⁴ Asplundh "Input Methodologies Review - draft decisions, topic 7: Related Party Transactions" (11 August 2016).

Overarching problem	Focus areas	What are we seeing which points to this being a problem?	Effect of the problem	Materiality of potential impact on consumers
	Transparency of the valuation of transactions	<p>Directors' certification has effectively become a default option to use in disclosing the valuation of related party transactions for some regulated suppliers. This results in a lower level of transparency that prices achieved are equivalent to arm's-length terms as there is no visibility in how directors have satisfied that conclusion.⁴⁵</p> <p>In particular, we have seen increased values of related party transactions using director certification in information disclosures and limited or no use of some other valuation options available. There does not seem to be consistent reasoning from regulated suppliers as to the use of this option.⁴⁶</p>	Decreased confidence in ID. This makes it hard for us to assess whether any efficiencies are being shared with consumers of the regulated service or if these are being enjoyed by the related party.	<p>Medium</p> <p>Not all disclosure valuation options provide for limited transparency.</p>
	Compliance with the prescribed rules	The way in which the original rules were drafted has led to some suppliers charging a margin in excess of the 17.2%, which was intended to allow for the recovery of overhead costs experienced by the related party. This is either by charging a higher margin and using director certification or by structuring their business in a way to receive a greater combined margin.	Valuation of transactions may be affected. If prices charged by related parties are too high, this would adversely affect the consumers of the regulated service.	<p>Medium</p> <p>Our focus is ensuring any efficiency gains made from the use of a related party are passed through to the consumer.</p>

⁴⁵ We acknowledge that the original related party provisions did not require such additional disclosure.

⁴⁶ Our intention was for director certification to only be used when none of the other options apply. See Commerce Commission "Information Disclosure for EDBs and GPBs Final Reasons Paper" (1 October 2012), para 3.50.

Submissions received on our problem definition paper

3.10 We concluded on balance that the submissions received confirmed our problem definition and a number provided suggestions on how we could update the related party transactions provisions to address the problem. We have taken these into account in the solutions in Chapters 4 and 5.

3.11 We received a range of submissions on our problem definition paper, with some submitters agreeing that there is a clear problem, and others considering the problem to be overstated.

3.12 MEUG supported our interpretation of the problem definition, noting:⁴⁷

The related party provisions are not leading to outcomes consistent with the purpose of Part 4 of the Act relative to an alternative set of provisions.

3.13 Several submitters supported our problem definition that the policy intent could be better implemented through a review of the original rules. For example, in its submission, Powerco stated:⁴⁸

Aspects of the current design are difficult to interpret and therefore implement. The difficulties we have experienced appear to be common to suppliers as evidenced in the Commission’s findings. We have found the complexity of the rules and inconsistency between IMs and IDD (sic) particularly troublesome. We welcome a review of these rules.

3.14 We have considered submissions on the complexity of the original regime in devising our amendments outlined in Chapters 4 and 5.

3.15 Conversely, some submissions on our problem definition paper disagreed with our problem definition, stating that the original provisions met the policy intent. For example, Wellington Electricity Lines Limited (**WELL**) submitted:⁴⁹

WELL considers that with the exception of some improvement to the design and structure of the related party rules, the existing provisions in the input methodologies and information disclosure requirements are working effectively to support this policy.

⁴⁷ MEUG “MEUG to CC, Related Party Transactions” (17 May 2017), para 5.

⁴⁸ Powerco “Powerco submission on problem definition” (17 May 2017), page 3.

⁴⁹ Wellington Electricity Lines Limited “Wellington Electricity Lines Limited – IM submission – related party transactions problem definition” (17 May 2017), page 1.

- 3.16 Based on our learnings from discussions with other suppliers of regulated services in the EDB sector and our subsequent further analysis, we do not agree with WELL's comment.⁵⁰ We instead agree with MEUG that the original provisions allowed for outcomes that are not consistent with the Part 4 purpose, and we have considered this in developing our amendments.
- 3.17 Several submissions were concerned that the Commission's view of the degree of the potential problem was overstated, citing a lack of evidence that regulated suppliers are inherently biased towards related party transactions that do not meet an arm's-length standard. For example, Aurora stated in its submission on the problem definition paper:⁵¹
- We are yet to see evidence of related parties supplying inputs at excessive prices under the current RPT rules. Aurora considers that evidence of over-payments is needed to justify tightening of the RPT rules.
- 3.18 Given the fact that the total volume and value of related party transactions are large and growing, we are concerned that the potential for consumer harm could be significant.⁵² However, with the way the original prescriptive set of rules were set out, it is correct that we were unable to conclude whether a large share of the related party transactions met the arm's-length standard.
- 3.19 Nova stated in its submission that the number of specific instances where the original related parties regime was being abused was difficult to identify, given that:⁵³
- 3.19.1 beneficiaries of such arrangements will not object;
 - 3.19.2 inadequate disclosure requirements make it difficult for disadvantaged competitors to establish evidence of non-arm's-length practices; and
 - 3.19.3 consumers that indirectly incur the costs have no real engagement.

⁵⁰ Our discussions with suppliers of regulated services are set out in our problem definition paper.

⁵¹ Aurora "Aurora Submission - RPT Problem Definition" (17 May 2017), page 1. We note that Aurora made a similar point in its submission on the draft decision paper: Aurora Energy "Submission: Related party transactions: Draft decision and determinations guidance" (27 September), page 3.

⁵² The scale of related party transactions across EDB opex and capex can be seen in Figures 3.2 to 3.4 of Commerce Commission "Related party transactions – Invitation to contribute to problem definition" (12 April 2017). For the most recent disclosure data (year to 31 March 2017), refer to our performance summaries for electricity distributors published on the Commission's website: <http://www.comcom.govt.nz/dmsdocument/15808>.

⁵³ Nova "Nova submission IM review - Related Party Transactions" (17 May 2017), page 1.

- 3.20 Our view of the potential materiality of the problem is supported by the ERANZ submission on the problem definition paper.⁵⁴
- 3.21 Submissions on our problem definition paper proposed that many of the problems in the regime could be resolved by replacing the complex and inconsistent provisions with a principles-based approach.⁵⁵
- 3.22 In particular, we have noted the submission points regarding the perceived degree of the problem and have attempted to ensure that the approach we have adopted to the general valuation rule and the specific ID requirements is scaled appropriately for the issue.

⁵⁴ ERANZ “ERANZ submission on Related Party Transactions Issues Paper” (17 May 2017), para 5.1.

⁵⁵ For example, PwC “PwC group submission on related parties” (17 May 2017), para 7; ENA “ENA submission on IM review - Related Party problem definition” (17 May 2017), para 11.

Chapter 4 Our amendments to the valuation methodology and key definitions

Purpose of this chapter

- 4.1 This chapter provides:
- 4.1.1 an outline of our original approach;
 - 4.1.2 our new principles-based valuation methodology;
 - 4.1.3 our updated annual ID audit requirements amended to align with the new valuation methodology; and
 - 4.1.4 our amendments to key definitions to implement the new valuation methodology.

Our original approach

- 4.2 Our original related party transactions provisions included prescriptive valuation options. We required suppliers of regulated services to disclose related party transactions using one of an identified list of options. We had:
- 4.2.1 nine valuation methodology options for capex supplied by related parties;⁵⁶
 - 4.2.2 seven valuation methodology options for opex supplied by related parties;⁵⁷ and
 - 4.2.3 three valuation methodology options for revenue received from related parties.⁵⁸

⁵⁶ *Electricity Distribution Services Input Methodologies Determination 2012 – (consolidated as of 28 February 2017)*, clause 2.2.11(5); *Gas Distribution Services Input Methodologies Determination 2012 – (consolidated as of 28 February 2017)*, clause 2.2.11(5); and *Gas Transmission Services Input Methodologies Determination 2012 – (consolidated as of 28 February 2017)*, clause 2.2.11(5).

⁵⁷ *Electricity Distribution Information Disclosure Determination 2012 – (consolidated in 2015)*, clause 2.3.6; *Gas Distribution Information Disclosure Determination 2012 – (consolidated in 2015)*, clause 2.3.6; and *Gas Transmission Information Disclosure Determination 2012 – (consolidated in 2015)*, clause 2.3.6.

⁵⁸ *Electricity Distribution Information Disclosure Determination 2012 – (consolidated in 2015)*, clause 2.3.7; *Gas Distribution Information Disclosure Determination 2012 – (consolidated in 2015)*, clause 2.3.7; and *Gas Transmission Information Disclosure Determination 2012 – (consolidated in 2015)*, clause 2.3.7.

- 4.3 The feedback we received from auditors and the submissions we received on our problem definition consultation paper informed us that the rules of the prescriptive valuation options could be difficult to interpret and apply in practice.⁵⁹
- 4.4 We consider our original prescriptive valuation options could not be adequately re-written to:
- 4.4.1 ensure the related party policy intent was met; and
 - 4.4.2 address comments provided in submissions on the ability to apply the original rules in practice.

Our approach to developing the new valuation methodology

- 4.5 In assessing the best outcome for a new valuation methodology, we considered:⁶⁰
- 4.5.1 the best way of ensuring that the policy intent would be achieved and the Part 4 purpose would be promoted;⁶¹
 - 4.5.2 the need for clear alignment of related party provisions across the IMs and ID provisions;
 - 4.5.3 our understanding of the needs of the following stakeholders who will be applying the provisions, so as to avoid future interpretation issues, including:
 - 4.5.3.1 regulatory accountants completing annual disclosure documentation; and
 - 4.5.3.2 sector auditors completing ID assurance engagements;⁶² and

⁵⁹ Deloitte noted that the related party transactions rules are complex and it has had to resolve issues with an audit client on the varying interpretations of the rules, particularly the classification and measurement of related party transactions. Commerce Commission “Related party transactions – Invitation to contribute to problem definition” (12 April 2017), para 3.23. PwC noted that a significant source of complexity of the related party transactions rules is the level of prescription used in the original regime. PwC “Submission to the Commerce Commission on Input Methodologies review: Related party transactions – invitation to contribute to problem definition” (7 May 2017), para 6.

⁶⁰ Our considerations are consistent with the solutions outlined in Commerce Commission “Related party transactions – Invitation to contribute to problem definition” (12 April 2017), Table 5.1.

⁶¹ As outlined in Chapter 2.

⁶² Further detail of how we have considered the auditor is provided later in this chapter.

- 4.5.4 whether the new valuation methodology would be able to stay current in order to account for new developments in the sectors over future regulatory periods (eg, for the effects of emerging technologies).
- 4.6 In assessing the appropriateness of our new valuation methodology, we have also considered submissions on the draft decision paper. We have responded to these submissions in the relevant sections below.
- 4.7 This chapter should be read in conjunction with the de minimis threshold for disclosure requirements in paragraphs 5.6 to 5.13. If regulated suppliers meet a de minimis threshold, they will have reduced disclosure requirements (including removing the requirement to commission an independent report outlined in this chapter).⁶³

Details of our changes and our supporting reasoning

A principles-based approach to valuation and the general valuation rule

- 4.8 Consistent with the draft decision, we have adopted a principles-based valuation approach. That is, an amended regime with a general valuation rule which corresponds more closely to the policy intent. This replaces the list of options provided in the original prescriptive valuation approach.⁶⁴
- 4.9 The general valuation rule for related party transactions is that the cost of an asset or the value of a good or service acquired from a related party, or the price received from the sale or supply of an asset or good or service to a related party, must be set for the purposes of the IMs and ID on the basis that:⁶⁵
- 4.9.1 each related party transaction for an acquisition from a related party must be given a value at not greater than if that transaction had the terms of an arm's-length transaction;
- 4.9.2 each related party transaction for a sale or supply to a related party must be given a value at not less than if that transaction had the terms of an arm's-length transaction; and

⁶³ This threshold is intended to reduce unnecessary compliance costs by making disclosures proportional to the size and percentage of related party transactions.

⁶⁴ As a consequence of removing the options for capex, for CPP proposals we no longer require a director certification by the regulated supplier that it is reasonably satisfied that asset values are consistent with values determined in accordance with the capex option chosen.

⁶⁵ Table 4.1 provides reference to the general valuation rule in the IMs and ID determinations.

- 4.9.3 an objective and independent measure must be used in determining the terms of an arm's-length transaction.
- 4.10 This general valuation rule aligns directly with the terminology used in the related party policy intent, to address the problem that the original related party provisions were not well aligned with the policy intent. This rule is applied consistently as the valuation methodology in the IMs (related party capex transactions) and ID (related party opex and revenue transactions).⁶⁶
- 4.11 Regulated suppliers will need to disclose a methodology that looks to the competitive testing of markets and be seen to apply that methodology in practice.
- 4.12 Auditors of ID disclosures will be required to report against these requirements.
- 4.13 We consider the principles-based approach:
- 4.13.1 ensures that the policy intent and Part 4 purpose are being met;
 - 4.13.2 corrects the issue of the misalignment of the methodology in the IMs and ID in the original regime, by having an identical valuation methodology across both determinations for each sector;
 - 4.13.3 has a higher likelihood of covering all of the services likely to be provided by related parties and better anticipates emerging technology developments, enabling us to be both service and technology agnostic in drafting the new determination wording;⁶⁷
 - 4.13.4 removes determination drafting complexities in the original regime; and
 - 4.13.5 addresses the objective of greater transparency to ensure that related party transactions are based on arm's-length terms, and will more easily enable us to assess any future potential consumer harm.

⁶⁶ This attempts to address submission comments received on the problem definition paper that the related party rules in the original IMs and ID were not well aligned.

⁶⁷ Suppliers of regulated services have varying portfolios offering a range of services and with the advancement of emerging technologies in both the electricity and gas sectors, our amendments aim to remain applicable to a range of services and future sector developments.

- 4.14 Submissions on our draft decision were supportive of the move to a principles-based approach. For example, PwC representing a number of EDBs submitted:⁶⁸

The EDBs which support this submission welcome the Commission's decision to introduce a principles based approach to related party transactions, supported and underpinned by written guidance and the incorporation by reference of accounting and auditing standards.

Our valuation methodology

- 4.15 Table 4.1 outlines our principles-based valuation methodology, how this is applied in the IM and ID determinations, and where it is further discussed in this paper.

⁶⁸ PwC "Submission to the Commerce Commission on Input methodologies review: draft decision on related party transactions" (27 September 2017), para 5.

Table 4.1 Summary of our principles-based valuation methodology and associated assurance features

Consideration	Outline	Determinations	Reasons paper
General valuation rule (IMs)	<p>The general valuation rule for related party transactions is that the cost of a commissioned asset, or a component of a commissioned asset, acquired in a related party transaction, must be set on the basis that:</p> <ul style="list-style-type: none"> (a) the cost of a commissioned asset or a component of a commissioned asset acquired in the related party transaction must be given a value not greater than if that transaction had the terms of an arm’s-length transaction; and (b) an objective and independent measure must be used in determining the terms of an arm’s-length transaction for the purpose of paragraph (a). 	IMs	Paragraphs 4.8–4.13.
General valuation rule (ID)	<p>The general valuation rule for related party transactions is that the value of a good or service acquired in a related party transaction, or the amount received for the sale or supply of assets or goods or services in a related party transaction, must be set on the basis that:</p> <ul style="list-style-type: none"> (a) the value of a good or service acquired in the related party transaction must be given a value not greater than if that transaction had the terms of an arm’s-length transaction; (b) the value of an asset or good or service sold or supplied in the related party transaction must be given a value not less than if that transaction had the terms of an arm’s-length transaction; and (c) an objective and independent measure must be used in determining the terms of an arm’s-length transaction for the purpose of paragraph (a). 	ID	Paragraphs 4.8–4.13.

Consideration	Outline	Determinations	Reasons paper
Value limitation (IMs)	<p>The rules incorporate a value limitation:</p> <p>Where a commissioned asset or a component of a commissioned asset is acquired in the related party transaction, the value that qualifies for recognition as the cost of a commissioned asset or a component of a commissioned asset must not exceed the actual amount charged to the regulated supplier by the related party</p>	IMs	Paragraphs 4.20–4.27.
Value limitation (ID)	<p>The rules incorporate a value limitation:</p> <p>Where a good or service is acquired in the related party transaction, the value of the good or service must not exceed the actual amount charged to the regulated supplier by the related party</p>	ID	Paragraphs 4.20–4.27.
Consolidation approach (IMs)	<p>A related party transaction will be treated as if it had the terms of an arm’s-length transaction if the commissioned asset, or component of the commissioned asset, acquired from a related party is valued at the cost incurred by the related party, provided that this is -</p> <ul style="list-style-type: none"> (a) fair and reasonable to the regulated supplier; and (b) substantially the same as the cost that has been incurred or would be incurred by the related party in providing the same type of asset to third parties. 	IM	Paragraphs 4.28–4.30
Consolidation approach (ID)	<p>A related party transaction will be treated as if it had the terms of an arm’s-length transaction if the good or service acquired from a related party is valued at the cost incurred by the related party, provided that this is-</p> <ul style="list-style-type: none"> (a) fair and reasonable to the regulated supplier; and (b) substantially the same as the cost that has been incurred or would be incurred by the related party in providing the same type of good or service to third parties. 	ID	Paragraphs 4.28–4.30

Consideration	Outline	Determinations	Reasons paper
Independent audit assurance requirements (ID)	<p>In satisfying the valuation methodology, the audit assurance opinion states whether the valuation and disclosure of related party transactions in the disclosure year in all material respects complies with the general related party transactions valuation rule.</p> <p>As part of the audit assurance opinion, the auditor must state any 'key matters'.⁶⁹</p>	ID	Paragraphs 4.35–4.46.

⁶⁹ We have incorporated these principles from IAS (NZ) 701.

Consideration	Outline	Determinations	Reasons paper
Independent report (ID)	<p>The supplier of the regulated service will be required to seek an independent assurance report if:</p> <ul style="list-style-type: none"> (a) the proportion of the regulated supplier’s total opex accounted for by related party transactions exceeds 65% of the total opex of the regulated supplier in the disclosure year;⁷⁰ or (b) the proportion of the regulated supplier’s total capex accounted for by related party transactions exceeds 65% of the total capex of the regulated supplier in the disclosure year; or (c) the auditor of the ID requirements is unable to conclude that the related party transactions in the disclosure year in all material respects complies with the general related party transactions valuation rule; or (d) the independent auditor issues a modified audit opinion for the disclosure year and time constraints do not permit the preparation of an independent report for that disclosure year, in which case the report will need to be provided with the following year’s disclosures; or (e) the last prior independent report was not commissioned by the regulated supplier in respect of one of the immediately prior two disclosure years; and (f) the total value of related party transactions in opex or capex has increased by 5% or more between the disclosure year addressed in the prior report. 	ID	Paragraphs 4.47–4.60.

⁷⁰ For example, if the related party opex spend was greater than 65% of total opex spend in a disclosure year, then the supplier of the regulated service will be required to seek an independent report.

Expected characteristics of an arm's-length relationship and transactions

4.16 The arm's-length principle aims to achieve the equivalent of a transaction between the supplier of the regulated service and the related party that reflects the conditions that would have existed if the terms of the transaction had been governed by market forces between independent parties.

4.17 For this purpose we have adopted the wording for 'arm's-length transaction' from the definition in auditing standard ISA (NZ) 550:⁷¹

Arm's length transaction means -

A transaction conducted on such terms and conditions as between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interests.

4.18 This will ensure that there is a direct linkage between our requirements and the work that auditors will carry out to test our requirements under the applicable auditing standard.

4.19 The definition in this case is also consistent with the applicable term used in the Electricity Industry Act.⁷²

Value limitations

4.20 To ensure that the amended rules do not open the door to adjustments to the actual transaction values for regulatory purposes, the rules now incorporate the following value limitation:

4.20.1 Where an asset or good or service is acquired in the related party transaction, the value of the asset or good or service must not exceed the actual amount charged to the regulated supplier by the related party.⁷³

4.21 This is intended to set an upper value limit for procured goods, services and assets, in order to remove the opportunity for the supplier of the regulated service to add an additional margin above the actual amount charged when costing it into the regulated service. Such an additional margin could result in the regulated service incorporating inefficient costs.

⁷¹ External Reporting Board (XRB) "International standard on auditing (New Zealand) 550 – Related Parties (ISA (NZ) 550)." Compiled November 2016 and incorporating amendments up to and including October 2016, page 9.

⁷² Clause 1(2) of Schedule 3 of the Electricity Industry Act 2010.

⁷³ Table 4.1 provides reference to the value limitation in the IMs and ID determinations.

4.22 Vector submitted that the Commission should reconsider this limit to the general valuation test:⁷⁴

We find it counter-intuitive that suppliers must submit actual costs if their RPT are in fact below the market. This will ultimately result in such costs being calibrated at the resetting of a regulatory period (for a price-quality regulated business) at below the market rate. The consequence of such an outcome is that it will ultimately “lock out” the market.

4.23 However, we disagree that it is counter-intuitive to require regulated suppliers to disclose the actual amount charged if this is less than an arm’s-length value demonstrated based on an objective and independent measure.

4.24 We consider that if a regulated supplier is able to procure assets, goods or services at below an arm’s-length value, this would ultimately promote the long-term benefit of consumers. This is because the lower price would result in a lower input cost for the regulated service.

4.25 It is correct that for a price-quality regulated supplier, disclosure of such a lower input cost would most likely result in such cost being calibrated at each reset of the price-quality path, especially if there is a trend to transact at such lower values over a number of years. However, we do not consider this is a sufficient argument for restating these actual transaction values up to arm’s-length values for disclosure purposes.

4.26 In our view, any exclusion of competitors (ie, “lock out” of the market) due to predatory pricing occurs as a result of the prices actually charged, not as a result of the values disclosed under ID. We therefore do not consider this exclusion issue would be appropriately resolved if actual transaction values were required to be restated for ID purposes, because it could result in the additional recovery of revenues by the regulated supplier and additional cost to consumers if those disclosed restated values were then also adopted in setting the price-quality path.

⁷⁴ Vector “Vector submission on the Review Related Party Transactions Review Draft Decision” (27 September 2017), paras 14–15.

- 4.27 As previously stated in our problem definition paper,⁷⁵ we have also considered a value limitation for sales from a regulated supplier to a related party as part of this review. Our final decision is that these sales should be disclosed at no less than the actual amount received from the related party.⁷⁶

Consolidation approach

- 4.28 In response to submissions,⁷⁷ our final decision is to retain the consolidation (or cost-based) approach as a ‘safe-harbour’ for demonstrating compliance with the general valuation principle under the IMs and ID determination. Consolidation combines the accounting figures of the regulated supplier and related parties, and eliminates inter-company margins.
- 4.29 If the consolidation approach is applied, there is no ability to place margins on internal costs. This reduces one potentially significant source of inefficiency in the price that consumers pay for the regulated service.
- 4.30 We consider that this method for meeting the IM and ID general valuation rule meets the policy intent and should be retained as a method of demonstrating compliance with the IM and ID general valuation rule. This is supported by the ENA, which suggested that the Commission should continue to permit EDBs to recognise services using cost-based methods (including the consolidation approach).⁷⁸

The role of auditors and alignment with related party auditing standard

- 4.31 The auditors completing assurance engagements on suppliers’ annual disclosures will be required to provide an assurance report as to whether, in the independent auditor’s opinion, the supplier of the regulated service has complied in all material respects with the requirements of the relevant ID determination.⁷⁹ If the supplier of the regulated service has not complied with the requirements, the assurance report must state the requirements not met.

⁷⁵ Commerce Commission “Related party transactions – Invitation to contribute to problem definition” (12 April 2017), para 2.8.

⁷⁶ Although, these transactions are not a focus of our review and are much less common than related parties supplying the regulated supplier.

⁷⁷ For example, Unison “Valuation of Related Party Transactions” (27 September 2017), page 2.

⁷⁸ ENA “Input methodologies Review Draft decision on related party transactions: Submission to the Commerce Commission” (27 September 2017), para 12.

⁷⁹ The ID determinations include: *Electricity Distribution Information Disclosure Amendments Determination 2017* [2017] NZCC 33, clause 2.8.1(1)(c); *Gas Distribution Information Disclosure Amendments Determination (No.2) 2017* [2017] NZCC 34, clause 2.8.1(1)(c); and *Gas Transmission Information Disclosure Amendments Determination (No.2) 2017* [2017] NZCC 35, clause 2.8.1(1)(c).

- 4.32 Our amendments aim for greater alignment with auditing standards terminology to reduce interpretation issues. By aligning our determinations with auditing standards, we intend to also provide interested persons with increased certainty as to the level of testing required by the auditor in order to provide assurance that the related party transactions meet the arm’s-length principle.
- 4.33 Following submissions on our draft decision, our final decision incorporates key principles from the standards in the ID determinations rather than the standards themselves.⁸⁰
- 4.34 Further detail of how we have incorporated the relevant auditing and accounting standards by reference in accordance with the Act is provided in Attachment D of this paper.

Updated auditor requirements

- 4.35 In order not to overcomplicate or cause interpretation issues for the users of these rules, we have aligned the ID independent assurance requirement with the related party transaction auditing standard and the principles in the applicable accounting standard.
- 4.36 These standards now provide the related party transaction terms included in our general rule, eg, the arm’s-length principle. We are not attempting to re-interpret such terms.
- 4.37 Without limiting the nature and purpose of the audit assurance report generally, we have outlined the updated auditor requirements for related party transactions as part of the ID external assurance report requirements.
- 4.38 Auditors will be expected to complete a review of the disclosure requirements for related party transactions in accordance with the *International Standard on Assurance Engagements (New Zealand) 3000, Assurance Engagements Other than Audits or Reviews of Historical Financial Information* and *Standard on Assurance Engagements 3100 – Compliance Engagements*.⁸¹

⁸⁰ PwC in capacity as auditors “Submission to the Commerce Commission on Input methodologies review: draft decision on related party transactions” (27 September 2017), paras 24–30. We also obtained feedback from the OAG about drafting of the determination, as it is the appointer of a number of auditors in the EDB sector where these rules would be applied.

⁸¹ *International Standard on Assurance Engagements (New Zealand) 3000, Assurance Engagements Other than Audits or Reviews of Historical Financial Information*, issued by the New Zealand Auditing and Assurance Standards Board of the External Reporting Board in July 2014, under s 12(b) of the Financial

- 4.39 In order to test compliance with the valuation methodology, the updated assurance opinion will need to state whether the valuation and disclosure of related party transactions in the disclosure year, in all material respects, demonstrates compliance with the general related party transactions valuation rule.
- 4.40 Our amendments to the valuation methodology may lead to future qualified audit opinions in relation to related party transactions. In situations where a qualified audit opinion is provided, auditors may be guided by international standards.⁸² Although our final decision is to not incorporate some of these standards by reference into the ID determinations, as proposed in our draft decision,⁸³ we will instead require the assurance report to state any ‘key audit matters’. These ‘key audit matters’ directly incorporate the relevant principles from International Standard on Auditing (New Zealand) 701 (ISA (NZ) 701).⁸⁴
- 4.41 We identified that auditors may face difficulties in assessing arm’s-length terms where there are imperfect local markets, ie, where the related party is the only provider of a service in a region. In those cases, we would expect that regulated suppliers in these types of markets and their auditors might consider costs of similar services provided around New Zealand in benchmarking costs and possibly seek expert external advice to complete benchmarking.
- 4.42 If the auditor is unable to conclude that the related party transactions are on terms equivalent to arm’s-length, we expect the regulated supplier would receive a modified assurance opinion. Under the auditing standards, a ‘modified’ assurance opinion could be a disclaimer of opinion, a qualified opinion or an adverse opinion, which will depend on the reasons for the auditor being unable to conclude on an unqualified assurance opinion.

Reporting Act 2013; Standard on Assurance Engagements 3100 – Compliance Engagements issued by the External Reporting Board, under s 24(1)(b) of the Financial Reporting Act 1993.

⁸² Such comments could be provided in ‘emphasis of matter’ or ‘other matter’ paragraphs. This is consistent with the New Zealand equivalents to the International Standards on Auditing in respect of financial statements: No. 700: Forming an Opinion and Reporting on Financial Statements; No 705: Modifications to the Opinion in the Independent Auditor’s Report; and No. 706: Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor’s Report.

⁸³ See PwC in capacity as auditors “Submission to the Commerce Commission on Input methodologies review: draft decision on related party transactions” (27 September 2017), paras 24–30.

⁸⁴ International Standard on Auditing (New Zealand) 701, Communicating Key Audit Matters in the Independent Auditor’s Report, issued by the New Zealand Auditing and Assurance Standards Board of the External Reporting Board in October 2015, under s 12(b) of the Financial Reporting Act 2013.

- 4.43 If the related party transacts with third parties as well as the regulated supplier, reference to the related party's pricing of equivalent transactions with those third parties, if available, may support the auditor's conclusion on the arm's-length principle.
- 4.44 It will be up to the auditor's professional judgement as to whether it can gain sufficient evidence to conclude on whether the transaction terms are consistent with the arm's-length principle. Being able to do this will depend on whether the auditor can obtain sufficient information to show that the transaction terms between the related party and the third parties are largely consistent with those between the related party and the regulated supplier.
- 4.45 In our audit rules, we have included a threshold to allow auditors and independent appraisers to assess the compliance of the supplier of the regulated service above a level of materiality as determined by the auditor's judgement.⁸⁵

The form of assurance report

- 4.46 The ID determination sets out the form of the assurance report, which is based on the auditing standards for forming an opinion on financial statements. Those auditing standards were recently updated and they provide more detailed guidance than the assurance standards on which the independent report is based.⁸⁶

Independent report to provide additional assurance

- 4.47 In circumstances where the related party transactions are a material proportion of the disclosure year's total opex or capex spend, or the auditor is not able to come to an unqualified opinion in its assurance report on related party transactions, the supplier of the regulated service will be required to seek a further report from an independent expert. This report must be disclosed publicly by the regulated supplier.

⁸⁵ This was also suggested by PwC: PwC in capacity as auditors "Submission to the Commerce Commission on Input methodologies review: draft decision on related party transactions" (27 September), para 21.

⁸⁶ For further explanation, the Office of the Controller and Auditor-General provides summarised guidance on types of audit reports on its web site at <http://www.oag.govt.nz/2014/central-government/appendix1.htm>.

- 4.48 The supplier of regulated services would be required to obtain and disclose an independent report if:
- 4.48.1 the proportion of the regulated supplier's total opex accounted for by related party transactions exceeds 65% of the total opex of the regulated supplier in the disclosure year; or
 - 4.48.2 the proportion of the regulated supplier's total capex accounted for by related party transactions exceeds 65% of the total capex of the regulated supplier in the disclosure year; or
 - 4.48.3 the independent auditor of the ID requirements is unable to conclude that the related party transactions in the disclosure year (or the prior disclosure year if the auditor provides a qualified opinion and the independent report is unable to be commissioned in time), in all material respects, meet the general valuation rule; or
 - 4.48.4 the independent auditor has issued a modified assurance opinion for the valuation and disclosures of related party transactions for the preceding year and time constraints have prevented the preparation of an independent report for that disclosure year. In this instance, we require the regulated supplier to publicly disclose a statement indicating that they will publicly disclose an independent report for the preceding disclosure year.
- 4.49 The supplier of regulated services will not be required to obtain and disclose this independent report if:
- 4.49.1 the last prior report was commissioned by the supplier in respect of one of the immediately prior two disclosure years; and
 - 4.49.2 the total value of related party transactions of the supplier in each of opex or capex (as applicable) has not increased by more than 5% for any disclosure year since the disclosure year addressed in the last prior report.
- 4.50 The supplier of regulated services will also not be required to obtain and disclose this independent report if the regulated supplier meets a de minimis threshold, as outlined in Chapter 5.

- 4.51 In its audit submission, PwC questioned whether the 5% increase trigger is the most appropriate threshold to use.⁸⁷

The auditors' opinion on the disclosure of consistently applied policies should provide comfort that the policies and information disclosed previously remains appropriate.

- 4.52 This was reiterated by other submissions that suggested that the requirement for an independent report should only be triggered in instances where the auditor cannot form an opinion.⁸⁸
- 4.53 We consider that even if the auditor is able to form an opinion, it is still appropriate and consistent with the purpose of information disclosure regulation in section 53A of the Act to require an independent report. For suppliers of the regulated service that have a high proportion and value of related party transactions, requiring an independent report to be obtained and disclosed should provide additional transparency and tell the story behind the transactions (even if the auditor is able to form an opinion on the appropriateness of values).
- 4.54 This independent report will tell the story behind the related party transactions where one of the requirements in paragraph 4.48 applies. This will provide interested persons with sufficient information to understand the extent to which the policy intent, and the purpose of Part 4 of the Act are or are not being met (and why) in situations where there is increased potential for consumer harm.
- 4.55 We note that the auditor undertaking the assurance engagement may be engaged to complete this report, but the supplier of the regulated service may also choose a different independent expert to provide this report (we refer to the author of the independent report as the 'independent appraiser'). We consider that an independent report on valuation by a non-audit expert might be adopted by the auditor under the auditing standards in forming an overall audit opinion on the ID disclosures in the following (or current) disclosure year.

⁸⁷ PwC in capacity as auditors "Submission to the Commerce Commission on Input methodologies review: draft decision on related party transactions" (27 September 2017), para 44.

⁸⁸ For example, Powerco "RE: Input methodologies review draft decision - related party transactions" (27 September 2017), page 3.

- 4.56 The independent report will:
- 4.56.1 be addressed to the directors of the regulated supplier and to the Commission as the intended users of the report;
 - 4.56.2 be independent of the independent auditor's assurance report;
 - 4.56.3 be based on the information obtained, sampling of related party transactions and analysis undertaken, and state whether or not in the opinion of the independent appraiser, the regulated supplier's related party transactions would comply, in all material respects, with the related party provisions, and set out the grounds for that opinion;
 - 4.56.4 where the independent appraiser provides an opinion in the report that the related party transactions would not comply with our related party provisions, state the appraiser's opinion on the alternative transaction terms that could enable compliance with the arm's-length requirements;
 - 4.56.5 set out the qualifications of the independent appraiser to provide the opinion in the report;
 - 4.56.6 set out the scope and any limitations of the engagement of the independent appraiser by the regulated supplier;
 - 4.56.7 state all key assumptions made by the independent appraiser on which the analysis in the report relies;
 - 4.56.8 describe the basis used by the independent appraiser for sampling of related party transactions to inform the opinion in the report;
 - 4.56.9 describe the steps and analysis undertaken;
 - 4.56.10 summarise the steps the regulated supplier has taken to test whether related party transactions comply with the related party provisions;
 - 4.56.11 state whether or not, in the opinion of the independent appraiser, the steps taken by the regulated supplier are, considered to be, in all material respects, reasonable in the circumstances; and
 - 4.56.12 state whether the independent appraiser has obtained recorded information and explanations that they required and, if not, the information and explanations not able to be obtained.

- 4.57 We have reduced the level of prescriptiveness for the independent report from that which was set out in the draft ID determination, and have removed the requirement to disclose the steps taken by directors and management to test whether the related party transactions comply with the general valuation rule.⁸⁹
- 4.58 We are not prescribing the analysis required for the independent report, as this will vary based on the circumstances of the regulated supplier. However, we expect such analysis may include the review of financial records, business transactions, accounting practice and internal controls in respect of disclosed related party transactions of the regulated supplier.
- 4.59 In its audit submission, PwC queried how the opinion required from the independent report would differ from the auditors' report when setting out whether the ID and IM determination had been complied with.⁹⁰
- 4.60 The independent report is designed to be a more thorough investigation into the related party transactions and will explain the circumstances and background of the related party transactions. This is intended to provide information to interested persons about the related party transactions.

Regulated suppliers that are likely to provide an independent report initially

- 4.61 Based on the 2016 ID data, we consider the following suppliers could be required to provide an independent report:⁹¹
- 4.61.1 Alpine Energy;
 - 4.61.2 Aurora Energy;
 - 4.61.3 OtagoNet;
 - 4.61.4 The Lines Company;
 - 4.61.5 Electra;
 - 4.61.6 Northpower; and

⁸⁹ Submissions on our draft decision suggested reducing the prescriptiveness of the independent report, for example: PwC "Submission to the Commerce Commission on Input methodologies review: draft decision on related party transactions" (27 September 2017), para 40.

⁹⁰ PwC in capacity as auditors "Submission to the Commerce Commission on Input methodologies review: draft decision on related party transactions" (27 September 2017), para 39.

⁹¹ These suppliers had at least 65% related party expenditure for opex and/or capex, and would not have met the de minimis thresholds if those thresholds had applied in that disclosure year.

4.61.7 The Power Company Limited.

Linking our amended valuation methodology with the IM and ID determinations

- 4.62 Our valuation options for related party transactions are split across two determinations with the ID determinations covering related party opex and revenue transactions and the IMs covering related party capex.⁹²
- 4.63 Table 4.2 links the elements from our principles-based valuation methodology with the provisions in the amendments determinations.

⁹² Further detail of this split is provided in paras 2.12 to 2.19 of this paper.

Table 4.2 Cross-reference of our principles-based methodology

Elements of the valuation methodology	IM	ID	Reference
General valuation rule	Provided in the IMs for related party capex valuations.	Provided in ID for related party opex and revenue valuations.	IM clauses 2.2.11(1) and 2.2.11(5) ID clauses 2.3.6(1)-(3)
Value limitation	Provided in the IMs for related party capex valuations.	Provided in ID for related party opex valuations.	IM clauses 2.2.11(1) and 2.2.11(5) ID clause 2.3.6(4)
Indicative examples of arm's-length transactions	Not included in the determinations. A guidance note is provided in the ID determinations to guide interested persons from the determinations to the relevant part of this paper. Attachment B provides worked examples of transactions on arm's-length and non-arm's-length terms to provide greater clarity for those applying the valuation methodology.		Attachment B of this paper.
Independent audit requirement	Not included in the IMs.	Provided in ID.	ID clauses 2.8.1(1)-(2)
Independent report	Not included in the IMs.	Provided in ID.	ID clauses 2.8.2-2.8.5
Relationship between cost allocation and related party transactions	Not provided for in the determinations. Attachment A outlines how paragraphs (a) and (b) of the related party definition are expected to apply with the cost allocation rules. Attachment C sets out the relationship between the cost allocation and related party provisions to provide greater clarity to those applying the rules. A guidance note is provided in the ID determinations to guide interested persons from the determinations to the relevant part of this paper.		Attachment A and Attachment C of this paper.

Our amendments to key definitions

- 4.64 We have amended key definitions to provide for greater clarity. We note submissions received on the complexity of the original terminology. For example, as a result of the move to the principles-based approach, there is no longer the term 'directly attributable costs' in our determinations.⁹³
- 4.65 An outline of our key definitions is provided in Table 4.3.

⁹³ In response to PwC "Input methodologies review: Related party transactions – invitation to contribute to problem definition" (17 May 2017), Appendix A.

Table 4.3 Our amendments to key definitions

Term	Outline ⁹⁴	Status	Determination reference
Arm's-length transaction	<p>Arm's-length transaction means-</p> <p>A transaction conducted on such terms and conditions as between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interests.⁹⁵</p>	Update	IM clause 1.1.4(2)
ISA (NZ) 550	<p>ISA (NZ) 550 means-</p> <p>International Standard on Auditing (New Zealand) 550, Related Parties, issued by the New Zealand Auditing and Assurance Standards Board of the External Reporting Board in July 2011 and amended effective 15 December 2016, under s 24(1)(b) of the Financial Reporting Act 1993.</p>	New	ID clause 1.4.3
Related party	<p>Related party means-</p> <p>(a) a person that is related to the regulated supplier, where the regulated supplier would be considered as the 'reporting entity', as specified in the definition of 'related party' in NZ IAS 24; or</p> <p>(b) any part of the regulated supplier that does not supply regulated services.</p>	Update	IM clause 1.1.4(2)

⁹⁴ When referring to the regulated supplier we mean the EDB, GDB or GTB as applicable in the appropriate determinations. When referring to regulated service that is, the electricity distribution services or gas pipelines services as applicable in the appropriate determination.

⁹⁵ Definition taken directly from ISA (NZ) 550.

Term	Outline ⁹⁴	Status	Determination reference
Related party transaction	<p>Related party transaction means -</p> <ul style="list-style-type: none"> (a) the procurement of an asset or good or service from a related party by the part of the regulated supplier that supplies the regulated service; or (b) the sale or supply of an asset or good or service to a related party by the part of the regulated supplier that supplies the regulated service. 	Update	IM clause 1.1.4(2)

Interpreting the definition of ‘related party’ and applying it in combination with cost allocation

4.66 We have amended the definition of ‘related party’ in the IMs to:

Related party means-

(a) a person that is related to the [EDB/GDB/GTB], where the [EDB/GDB/GTB] would be considered as the ‘reporting entity’, as specified in the definition of ‘related party’ in NZ IAS 24;⁹⁶ or

(b) any part of the [EDB/GDB/GTB] that does not supply [electricity distribution services/gas distribution services/gas transmission services].

4.67 Submissions on our draft decision paper sought the removal of paragraph (b) of the definition of ‘related party’. For example, Marlborough Lines Limited stated in its submission:⁹⁷

We submit that part (b) of the Related Party definition be removed and the Commission revert to a definition that would line up with the accounting standards definition of a Related Party, which requires a separate legal entity.

4.68 Paragraph (b) of the definition is included because the Commission regulates services and does not regulate the legal entity that supplies those services. From a policy intent point of view we consider that our related party transactions rules should address the various ways in which costs are charged to the regulated service, including charges made to the regulated service from an unregulated part of the entity.⁹⁸

4.69 We do not agree with arguments that removal of paragraph (b) from the definition of ‘related party’ would not compromise the policy intent. We consider that removing paragraph (b) could create a risk that internal transactions between the part of the entity that supplies the regulated service, and the part of the same entity that does not supply the regulated service, may not be disclosed on terms equivalent to arm’s-length.

4.70 This is critical to consumers, because some of the costs of those transactions may also be inputs into the regulated service.

⁹⁶ A ‘reporting entity’ is defined in NZ IAS 24 as the entity that is preparing its financial statements. In this case, the entity is the regulated supplier.

⁹⁷ Marlborough Lines Limited “Submission to the Commerce Commission on related party transactions Draft decision and determinations guidance” (27 September 2017), para 24. See also, for example, Unison “Valuation of Related Party Transactions” (27 September 2017), pages 6–7.

⁹⁸ For example, section 54E of the Act states that the electricity lines service is regulated. Section 54C of the Act outlines the meaning of electricity lines services.

- 4.71 Accordingly, we consider that removing paragraph (b) and aligning the definition strictly to the definition of a related party under the accounting standards could materially weaken the achievement of the policy intent of the related party regime. We have therefore decided to retain paragraph (b) of the ‘related party’ definition.
- 4.72 Treating a ‘part’ of the regulated supplier as the business equivalent of a separate legal subsidiary or other related company of the regulated supplier could allow that internal part to charge for services on arm’s-length terms and derive unregulated arm’s-length margins as if it was a subsidiary.
- 4.73 We consider that removing paragraph (b) would change the neutrality of treatment between internal and external business structures for the purposes of these rules and seems likely to incentivise regulated suppliers to move their unregulated activities into subsidiary companies. It may also disincentivise regulated suppliers from business innovation that is ultimately of value to customers of the regulated service.
- 4.74 We note from submissions on our draft decision paper that submitters were unclear what “parts, branches or divisions” of the regulated supplier are that do not supply the regulated service.⁹⁹
- 4.75 As Powerco stated in its submission:¹⁰⁰
- Our concern relates to the second tier of the definition. It is unclear from the information provided exactly what ‘*parts, branches and divisions*’ of a regulated business would be considered to be a related party, i.e. deemed to not supply regulated services.
- 4.76 We have therefore reverted in paragraph (b) of the amended definition to the simpler “any part” in place of the proposed “parts, branches or divisions” and will be giving guidance to the regulated sectors on what a ‘part’ means.
- 4.77 To identify a ‘part’ of a regulated supplier first requires the definition of the regulated service and then the identification of activities and costs that are fundamental to providing that regulated service. Conversely it requires the identification of activities and costs that would allow the ‘part’ to operate as a separate business unit of the regulated supplier.

⁹⁹ Commerce Commission “Input methodologies review draft decision – Related party transactions – Draft decision and determinations guidance” (30 August 2017).

¹⁰⁰ Powerco “RE: Input methodologies review draft decision - related party transactions” (27 September 2017), page 2. See also, for example, Marlborough Lines Limited “Submission to the Commerce Commission on related party transactions Draft decision and determinations guidance” (27 September 2017), pages 2-4.

- 4.78 We looked at whether there are quantifiable dimensions that could be used to identify a ‘part’ so it would be clearer when the related party rules apply to internal business activities. In doing so, we considered whether to set brightline criteria in order for an unregulated business activity of a regulated supplier to be considered as a related party for the purposes of the related party transactions rules, but have concluded in line with our principles-based approach that this would be counter to our conclusions on updating the valuation rules.
- 4.79 We concluded based on our discussions with sector participants over the course of examining the related party transaction issues that business models are variable across both sectors and that it would not be practical to set criteria for when those business activities become a ‘part’.
- 4.80 This does theoretically leave open a risk that regulated suppliers could seek to convert elements of their regulated services into separate business units to allow a higher rate of return through pricing those cost elements up to an arm’s-length equivalent value.
- 4.81 However, for guidance to regulated suppliers we note that when we ultimately evaluate the information disclosures made in response to the related party transactions requirements set out in Chapter 5, we will be thinking about whether any internal related party for which disclosures are made would be capable of being considered a severable business from the regulated service, essentially considering what, if anything, distinguishes:
- 4.81.1 a ‘part’ of the regulated supplier that sells to the regulated service and to other external customers; and
 - 4.81.2 a regulated service that derives some revenues selling unregulated services to external customers.
- 4.82 Indicative factors we could consider might include whether the business has the management and operating structure we would expect of a standalone business, and whether it already has the scale of third party sales and a clear focus on growing external sales and reducing reliance on internal sales that would be expected of such a business.
- 4.83 For example, where an internal part of the regulated supplier has been operating for some time as an identified business unit, its unregulated supplies to external customers exceed the unregulated supplies to the regulated service, and the unregulated service has a management, sales and support structure that seems theoretically capable of being separated from the regulated supplier, we would be likely to conclude that this is a ‘part’ of the regulated supplier for the purposes of paragraph (b).

- 4.84 Conversely, we would not expect a regulated supplier with a mere de minimis level of sales to third parties (for example, in an initial growth phase of the unregulated business unit), or with no established and tangible business structure, to be treated as a ‘part’ of the regulated supplier for the purposes of the related party transactions rules. In those instances we would instead expect to see a cost-based approach disclosed.
- 4.85 In the event that we see future sector business structuring that we consider undermines the related party transactions policy intent, our response could be a move back toward a more prescriptive and less flexible cost-based approach.
- 4.86 Paragraphs (a) and (b) of the related party definition can apply in different combinations depending on how a regulated supplier is structured from an ownership and operational point of view, and how it transacts with other companies. For example, in a case where a regulated supplier provides both regulated services and unregulated services:
- 4.86.1 If the regulated supplier does not have a separate business unit that charges costs to the regulated service, and input costs are charged to the regulated supplier by an unrelated third party, the cost allocation rules deal with how the transaction values of those input costs are to be allocated between the services;
- 4.86.2 If external input costs are charged to the regulated service through a separate business unit of the regulated supplier (ie, a ‘part’) at the transaction cost charged by the unrelated third party, and they include no additional margin for the ‘part’ on top of that transaction cost, the cost allocation rules apply; and
- 4.86.3 If the amount charged to the regulated service by the internal ‘part’ includes a further margin and is therefore more than just a pass-through of third party charges to the regulated service, the related party transactions rule applies in combination with the cost allocation rules.¹⁰¹

¹⁰¹ Although we can see the potential for “double dipping” of shared costs in the paragraph (b) ‘part’ of the regulated supplier through the cost structure of the ‘part’ and through the cost allocation rules in the regulated service, this is something that we expect will be disclosed through the information disclosures in Chapter 5.

- 4.87 A logical way to apply the related party rule, if applicable, and the cost allocation rules is to first value the transactions at an arm's-length value under the related party valuation rule and then to make any necessary allocation of the resulting arm's-length value using the cost allocation rules.
- 4.88 To help interested parties understand the rules, we provide guidance in Attachment A on how the related party transaction rules and cost allocation rules would work in combination under a series of scenarios.
- 4.89 We provide a diagram in Attachment C that shows how and when to value a transaction with a related party that has a cost allocation requirement.
- 4.90 To give regulated suppliers a further opportunity to ask questions about the practical application of these rules to their circumstances, we also intend to include this topic as part of our education sessions in 2018.
- 4.91 We note that in our draft decision, we proposed providing a guidance note in the IM determinations on the interpretation of paragraph (b) of the 'related party' definition, as well as on other areas of the IM determinations. Some submissions considered that guidance notes should not be included in the IMs and ID determinations.¹⁰²
- 4.92 We agree and have therefore removed the guidance notes from the IM determinations. However, we still think it is appropriate to retain guidance notes in the ID determinations in the interests of guiding regulated suppliers and interested persons through the disclosure requirements.

¹⁰² For example, see PwC "Submission to the Commerce Commission on Input methodologies review: draft decision on related party transactions" (27 September 2017), para 42.

Chapter 5 Our amended related party disclosure requirements

Purpose of this chapter

- 5.1 This chapter provides:
 - 5.1.1 an outline of our amended related party disclosure requirements;
 - 5.1.2 our reasons for the amendments; and
 - 5.1.3 comments on our consideration of relevant submissions we have received on the draft amended disclosure requirements.

Our related party disclosure requirements

- 5.2 As outlined in our problem definition paper, we consider that the original related party transactions provisions provided limited transparency to enable stakeholders to assess whether:
 - 5.2.1 the cost of a good or service acquired from a related party, is set on the basis that each related party transaction is valued at not greater than if it had the terms of an arm's-length transaction;
 - 5.2.2 the price received from the sale or supply of an asset or good or service to a related party, is set on the basis that each related party transaction is valued at not less than if it had the terms of an arm's-length transaction;
 - 5.2.3 the value of a related party transaction is based on an objective and independent measure; and
 - 5.2.4 cost efficiencies are being shared with consumers of the regulated service.
- 5.3 Our original ID requirements for related party transactions were focussed on quantitative data collection and may not have provided sufficient qualitative information that is readily available to interested persons to assess whether the Part 4 purpose is being met as set out in s 53A.
- 5.4 We have amended our rules to promote greater transparency of related party transactions to ensure that these transactions comply with the policy intent and to ensure that the s 53A ID purpose is being met. We have made some amendments to the disclosure requirements in response to submissions on our draft decision. In particular, we removed some of the disclosure requirements proposed in our draft decision to reduce compliance costs on suppliers.

5.5 The ID amendments we have made are set out under the relevant headings below.

Limited disclosure requirements in some cases

5.6 In situations where a regulated supplier has minimal related party transactions or otherwise has lower levels of total expenditure, we are less concerned that our policy intent would not be met. Therefore, requiring compliance with the full related party rules may not be a proportionate response.

5.7 We agreed with submissions on our draft decision that requiring all suppliers to comply with the full disclosure requirements may impose disproportionate compliance costs on some suppliers.¹⁰³

5.8 Submissions on our draft decision proposed introducing a de minimis threshold for application of the related party rules and disclosure requirements.¹⁰⁴ As Vector stated in its submission:¹⁰⁵

The cost of having low value transactions subject to the disclosure requirements and the general valuation rule will increase the administrative burden and costs for compliance and outweigh any benefit to be gained. A de-minimis threshold also provides a clear protection for the customer from having inflated costs included in the regulated service price.

5.9 We consider that a de minimis threshold will ensure that compliance costs are proportionate to the size of the supplier and its level of related party transactions.

5.10 Our decision is that the de minimis thresholds, below which only limited disclosure is required, will be where a supplier has:¹⁰⁶

5.10.1 total annual expenditure of \$20 million or less; or

5.10.2 under 10% of total annual expenditure made up of related party transactions.

¹⁰³ PwC in capacity as auditors “Submission to the Commerce Commission on Input methodologies review: draft decision on related party transactions” (27 September 2017), para 11.

¹⁰⁴ For example, Powerco “RE: Input methodologies review draft decision – related party transactions” (27 September 2017), page 3.

¹⁰⁵ Vector “Vector submission on the Review Related Party Transactions Review Draft Decision” (27 September 2017), para 8.

¹⁰⁶ *Electricity Distribution Information Disclosure Amendments Determination 2017* [2017] NZCC 33, clause 2.3.9; *Gas Distribution Information Disclosure Amendments Determination (No.2) 2017* [2017] NZCC 34, clause 2.3.9; and *Gas Transmission Information Disclosure Amendments Determination (No.2) 2017* [2017] NZCC 34, clause 2.3.9.

- 5.11 We consider that the de minimis threshold requirements strike a reasonable balance between cost on suppliers and effectiveness of the regime. We used our judgement to set the annual expenditure de minimis threshold and the percentage of related party transactions de minimis threshold at values that we consider will ensure that sufficient information is provided for interested persons to be able to evaluate whether the purpose of Part 4 is being met, but would also exclude any requirement for full disclosures by regulated suppliers where the resulting compliance cost is likely to be disproportionate to the value to interested persons of such disclosures.
- 5.12 Regulated suppliers that do not meet a de minimis threshold for a given disclosure year will be required to comply with the disclosure requirements set out in the following sections. The full disclosure requirements are summarised in Table 5.1. Table 5.2 then compares the disclosure requirements for full disclosure with the more limited level of disclosures when a regulated supplier meets a de minimis threshold.
- 5.13 We reviewed the potential application of the de minimis thresholds to EDBs, being the larger group of regulated suppliers for which related party information is available. Based on the 2016 ID data for EDBs, we estimate that in the first disclosure year:
- 5.13.1 ten regulated suppliers will be required to comply with the full disclosure requirements; and
 - 5.13.2 nineteen regulated suppliers will only be required to comply with limited disclosure by meeting a de minimis threshold.

Table 5.1 Related party disclosure requirements

Area	Overview ¹⁰⁷	Reference
Related party relationships	<p>A diagram or a description that shows the connection between the regulated supplier and the related parties with which it has had related party transactions in the disclosure year, including for each of those related parties -</p> <ul style="list-style-type: none"> (a) the relationship between the regulated supplier and the related party (b) the principal activities of the related party; and (c) the total annual expenditure incurred by the regulated supplier with the related party. 	ID clause 2.3.8
Procurement policies and processes	<p>Where the regulated supplier transacts with related parties in the disclosure year, provide a copy of the current procurement policy or alternate documentation. We note that the regulated supplier will be required to disclose a summary of the current procurement policy or alternative documentation publicly and the full version to the Commission.</p> <p>A description of how the regulated supplier applies its policy for the procurement of assets or goods or services from a related party in practice.</p> <p>A description of any policies or procedures that require or have the effect of requiring a consumer to purchase assets or goods or services from a related party that are related to the supply of the regulated service.</p>	ID clauses 2.3.10 – 2.3.11, 2.3.12(1)–(2)

¹⁰⁷ When referring to the regulated supplier we mean the EDB, GDB or GTB, as applicable, in the appropriate determinations. When referring to regulated services we mean the electricity distribution services or gas pipelines services, as applicable, in the appropriate determination. Full drafting detail can be found by following the references column.

Area	Overview ¹⁰⁷	Reference
Practical application of the procurement policies and processes	Where the regulated supplier transacts with related parties, disclose consistency of the practical application with the procurement policy through at least one representative example. Where a regulated supplier applies the current procurement policy differently between expenditure categories, it must provide separate representative examples that demonstrate the significant differences.	ID clauses 2.3.12(3), (5)
Most recent examples of market testing of transaction terms	Where the regulated supplier transacts with related parties, for at least one representative example, show how and when the regulated supplier last tested the arm's-length terms, by reference to market transactions. If there are significant differences between how the market has been tested for different expenditure categories, the regulated supplier must provide separate representative examples that demonstrate the differences.	ID clause 2.3.12(4)

Area	Overview ¹⁰⁷	Reference
Map of anticipated network expenditure and network constraints	<p>Where a regulated supplier has related party transactions during the disclosure year, the regulated supplier must publicly disclose a map of its regulated service territory, which includes –</p> <ul style="list-style-type: none"> (a) A brief explanatory description of the ten largest forecast opex projects in the asset management plan (AMP) planning period and the likely timing, value and location of the projects; (b) A brief explanatory description of the ten forecast capex projects in the AMP planning period and the likely timing, value and location of the projects; (c) A brief explanatory description of possible future network or equipment constraints and their location, where the responses to the constraints would involve one of the ten largest future opex projects in the AMP planning period; and (d) A brief explanatory description of possible future network or equipment constraints and their location, where the responses to the constraints would involve one of the ten largest future capex projects in the AMP planning period. <p>The map must –</p> <ul style="list-style-type: none"> (a) Identify whether the forecast or possible opex or capex is- <ul style="list-style-type: none"> a. Already subject to a contract, and, if so, whether that contract is with a related party; b. Forecast to require the supply of assets or goods or services by a related party; or c. currently not indicated for supply by a related party; and (b) Be consistent with the AMP information on – <ul style="list-style-type: none"> a. Network or equipment constraints; b. Projected impact of demand management initiatives (EDBs only); c. Network development programmes. 	ID clauses 2.3.13–2.3.16

Table 5.2 Disclosure requirements for regulated suppliers on full and limited disclosure

Requirement	Full disclosure (do not meet a de minimis threshold)	Limited disclosure (meet a de minimis threshold)
Related party relationships	✓	✓
Procurement policies and processes	✓	X
Practical application of the procurement policies and processes	✓	X
Recent examples of market testing	✓	X
Map of anticipated network expenditure and network constraints	✓	X
Valuation methodology	✓	✓
Report on Related Party Transactions (Schedule 5b) ¹⁰⁸	✓	✓
Audit and assurance requirements	✓	✓
Independent report	✓	X

¹⁰⁸ In our final decision, we have amended Schedule 5b of the EDB, GDB and GTB ID determinations. We proposed changes as part of our draft decision and received no submissions on our proposed changes.

Reasoning for our disclosure areas

Related party relationship

- 5.14 We have included a requirement to publish a diagram or description that explains the relationships between the related party and the supplier of regulated services to provide the Commission and interested persons with an overview of the business structure. We consider that such disclosure will provide interested persons with a high level overview of these regulatory structures.¹⁰⁹
- 5.15 The relationships intended to be covered would be ownership, governance and senior management between the parties. We consider such disclosure should be low cost for suppliers of regulated services to provide, as most will already have this information internally.
- 5.16 In response to concerns around compliance costs on our draft decision, we have reduced the specificity of this disclosure area in the ID determination.¹¹⁰ In particular, we have removed some of the requirements, including the requirement to disclose:
- 5.16.1 any common board or senior management;¹¹¹ and
 - 5.16.2 any common control or influence.

Procurement policies and processes

- 5.17 The disclosure of procurement policies and processes behind the procurement of assets and services from the related party helps to provide the required level of disclosures for interested persons to assess whether the related party transactions are meeting the related party policy intent and the Part 4 purpose. That is, that related party transactions do not adversely affect efficiency, profit, price and quality regulatory objectives.

¹⁰⁹ We agree with Pioneer's comment in its submission on the problem definition paper that if the regulated EDB selects a related party to be the supplier, and not a third party, the related party provisions must make the details of a related party transaction transparent. Pioneer Energy "Re: Related party transactions – invitation to contribute to problem definition" (17 May 2017), page 2.

¹¹⁰ *Electricity Distribution Information Disclosure Amendments Determination 2017* [2017] NZCC 33, clause 2.3.8; *Gas Distribution Information Disclosure Amendments Determination (No.2) 2017* [2017] NZCC 34, clause 2.3.8; and *Gas Transmission Information Disclosure Amendments Determination (No.2) 2017* [2017] NZCC 35, clause 2.3.8.

¹¹¹ PwC suggested less prescriptive disclosures focused on the nature and extent of related party relationships in their submission on our draft decision; PwC in capacity as auditors "Submission to the Commerce Commission on Input methodologies review: draft decision on related party transactions" (27 September 2017), para 13.

5.18 We have included this area of disclosure to ensure greater visibility, transparency and verification that regulated suppliers are delivering cost efficient assets and services.¹¹²

5.19 We have considered the following point from the Genesis submission on our standard track ID amendments process:¹¹³

3. Mandate disclosure of procurement processes generally and actual disclosure of the details of the process where an investment is over a specified threshold

This would increase the ability of interested persons to ascertain whether a robust procurement process was adhered to, particularly when procuring non-network solutions. At present, it is difficult to ascertain the extent to which EDBs give proper consideration to non-network solutions to deal with forecasted constraints and, in particular, whether EDBs adequately consider the use of customer-sited batteries.

5.20 Although the submission has a technology solution angle, we agree with Genesis' general point about the transparency of procurement processes and we have factored this into our solutions in a technology agnostic way.

5.21 We require a summary of the procurement policy information to be disclosed publicly with a full version of such documentation to be provided to the Commission. We consider this approach:

5.21.1 allows interested persons to identify whether a supplier has a procurement policy or not, and to examine any procurement policy; and

5.21.2 deals with any potential commercial confidentiality issues.

¹¹² The consideration for procurement policies is included in the following submissions on the problem definition paper: Asplundh "Input methodologies review – related party transactions – Invitation to contribute to problem definition / initial findings" (17 May 2017), page 1. Genesis Energy "Input methodologies review – Related party transactions – Invitation to contribute to problem definition" (17 May 2017), page 2.

¹¹³ Submission received from Genesis on "Commerce Commission Proposed amendments to information disclosure determinations for airport services, electricity distribution services, and gas pipeline services, Draft companion paper" (30 June 2017). Genesis Energy Limited "Proposed amendments to information disclosure determinations" (28 July 2017), page 5.

- 5.22 Some submissions on our draft decision did not support the publication of a summary of procurement policies.¹¹⁴ We consider that both disclosure of procurement policies and the publication of the summary of procurement policies better enables interested persons to assess whether or not the purpose of Part 4 is being met in accordance with s 53A.
- 5.23 We agree with ERANZ that the documentation of procurement practices and related entity transactions should already be being compiled as a routine part of a regulated supplier's internal processes to demonstrate their compliance with the provisions and intent of the Act.¹¹⁵ We expect under good governance practices, suppliers would be expected to have these policies and existing documentation.
- 5.24 A submission from Asplundh on the problem definition paper noted that contestable procurement processes can also support the development of local markets for providing these same services to the community.¹¹⁶ Where the opportunity exists for service providers to contest for service contracts, this supports the development (or establishment) of operations that can not only service the regulated supplier but also the wider community in a region.
- 5.25 In response to concerns from regulated suppliers around compliance costs in our draft decision, we have reduced the prescriptiveness of the procurement policies and processes disclosure in the ID determination.¹¹⁷
- 5.26 This disclosure is not required where a de minimis threshold is met, as summarised in Table 5.2.

¹¹⁴ For example, Vector "Vector submission on the Review Related Party Transactions Review Draft Decision" (27 September 2017), para 28.

¹¹⁵ ERANZ "Related party transactions – Invitation to contribute to problem definition" (17 May 2017), para 4.5.

¹¹⁶ Asplundh "Input methodologies review - related party transactions - Invitation to contribute to problem definition / initial findings" (17 May 2017).

¹¹⁷ *Electricity Distribution Information Disclosure Amendments Determination 2017* [2017] NZCC 33, clauses 2.3.10–2.3.11, 2.3.12(1), (3), (5); *Gas Distribution Information Disclosure Amendments Determination (No.2) 2017* [2017] NZCC 34, clauses 2.3.10–2.3.11, 2.3.12(1), (3), (5); and *Gas Transmission Information Disclosure Amendments Determination (No.2) 2017* [2017] NZCC 35, clauses 2.3.10–2.3.11, 2.3.12(1), (3), (5).

Practical application of procurement policies and processes

- 5.27 This disclosure requirement seeks to provide assurance to interested persons that the procurement policies and processes are a true representation of what is being consistently applied in practice in regards to related party transactions.
- 5.28 We would expect the description of practical application to include information such as:
- 5.28.1 key criteria or technical standards under which the supplier acquires the assets, goods or services;
 - 5.28.2 for each of the supplier’s related parties used in the disclosure year, the supplier’s reasons for using each related party;
 - 5.28.3 how the costs of assets, goods or services for related party transactions is set in practice; and
 - 5.28.4 changes since the preceding disclosure year in how the supplier applies the procurement policy.
- 5.29 In response to concerns around compliance costs in our draft decision, we have reduced the prescriptiveness of the practical application of procurement policies and processes disclosure in the ID determination.¹¹⁸ We have removed the requirement in the ID determination to describe how directors of the regulated supplier have decided whether or not the procurement policy has largely been applied in practice.¹¹⁹
- 5.30 This disclosure is not required where a de minimis threshold is met as summarised in Table 5.2.

¹¹⁸ *Electricity Distribution Information Disclosure Amendments Determination 2017* [2017] NZCC 33, clause 2.3.12(1), (3), (5); *Gas Distribution Information Disclosure Amendments Determination (No.2) 2017* [2017] NZCC 34, clause 2.3.12(1), (3), (5); and *Gas Transmission Information Disclosure Amendments Determination (No.2) 2017* [2017] NZCC 35, clause 2.3.12(1), (3), (5).

¹¹⁹ This was also suggested by PwC in their submission on our draft decision; PwC in capacity as auditors “Submission to the Commerce Commission on Input methodologies review: draft decision on related party transactions” (27 September 2017), para 17.

Policies requiring the purchase of unregulated goods or services

- 5.31 A regulated supplier's monopoly position in the regulated market could provide it with the ability to leverage that market power into neighbouring markets by requiring consumers of regulated services to purchase unregulated services from a related party of the regulated supplier.
- 5.32 We consider that there is a possibility that policies tying the purchase of regulated and unregulated services may damage the interests of consumers of regulated services, by forcing them to pay more for complementary unregulated services than they would if they were free to choose the supplier of unregulated services with whom they wished to deal. In our view, providing greater transparency in relation to such requirements would promote the long-term benefit of consumers of regulated services; in particular, by constraining the ability of regulated suppliers (through their related parties) to extract excessive profits.
- 5.33 A regulated supplier may have internal policies and procedures which contain these kinds of requirements. For example, a regulated supplier may have a policy which explicitly requires consumers to use its related party for vegetation management services, where the responsibility for managing vegetation is the responsibility of the consumer. Similarly, a regulated supplier may have a policy that requires contractors constructing new connections to its network to comply with certain standards, that in practice only its related party is able to comply with.
- 5.34 In order to reveal situations like this, in our draft decision we proposed requiring the disclosure of policies or technical requirements under which a regulated supplier referred customers to a related party in respect of goods or services related to the regulated service.
- 5.35 In its submission on our draft decision, Vector considered that the requirement to disclose policies or technical requirements when referring a customer to a related party was "unconnected to the matters raised in the Commission's problem definition" for related party transactions and "deviates from its statutory mandate under section 52A of the Act and could be considered beyond the limits of its power under Part 4 of the Act."¹²⁰

¹²⁰ Vector Limited "Vector Submission on the Review Related Party Transactions Review Draft Decision" (27 September 2017), paras 23 and 25.

- 5.36 We acknowledge that our use of the word ‘referral’ in the draft determination may have had the potential to be interpreted more expansively than we had intended.¹²¹ Accordingly, we have amended the wording in the final ID amendment determination to limit the application of the disclosure requirement to policies or procedures that require or have the effect of requiring a consumer to purchase assets or goods or services that are related to the regulated service from a related party.
- 5.37 We note, however, that a regulated supplier may engage in other activities that involve both regulated and unregulated services that do not necessarily involve a requirement or an effective requirement to purchase unregulated goods or services. Competition in markets for unregulated services, and consumers of regulated services, may well be adversely affected by such activities that may not involve a requirement per se but that nevertheless can be used to leverage the regulated supplier’s market power.
- 5.38 Although policies that relate to such activities may not be required to be disclosed under our ID rules, they may not comply with the provisions of Part 2 of the Act (just as conduct that is in accordance with a policy or procedure that we require to be disclosed may also not comply with Part 2 of the Act).
- 5.39 By requiring the disclosure of such policies and procedures, interested persons will be provided with information which will allow them to better assess whether the purpose of Part 4 is being met, consistent with the purpose of information disclosure set out in s 53A of the Act.

Recent examples of market testing of transaction terms

- 5.40 We have included disclosure requirements that detail how and when the regulated supplier last tested the arm’s-length terms of transactions (eg, by way of tendering, benchmarking or other method) for at least one representative example transaction.
- 5.41 If there are significant differences between how the current related party procurement policy has been applied between expenditure categories, the regulated supplier must provide separate representative example transactions that demonstrate the differences.

¹²¹ Vector Limited “Vector Submission on the Review Related Party Transactions Review Draft Decision” (27 September 2017), para 24.

- 5.42 This further disclosure will enable interested persons to assess whether the efficiency dimensions of the regulatory objectives of Part 4 have been adversely affected by a related party relationship and, in particular, whether the related party transactions reflect prudent and efficient costs on arm's-length terms.
- 5.43 The disclosure would also enable us to assess whether the related party transactions are consistently based on a demonstrated and objective measure as outlined in the policy intent. This will enable the Commission and other interested persons to gain an understanding of whether the related party transactions values entering the regulated supplier, for at least one representative example of market testing, have been tested to ensure efficient input costs for the regulated service.
- 5.44 Submissions on our problem definition paper commented on the importance of open and competitive tendering processes when procuring goods or services from contestable markets.¹²² However, we also understand the flipside that unnecessary external contracting can create inefficient transaction costs.¹²³
- 5.45 We have chosen not to impose prescriptive requirements as to how the supplier of the regulated service chooses to test the market. We have left testing methods to the regulated supplier's discretion and may be through benchmarking, open tender process, market testing of transaction terms, or another preferred process that sufficiently satisfies the auditor.
- 5.46 We consider this to be a low-cost approach as this should be information which the regulated supplier already has on record. Detailed disclosures will require regulated suppliers to assess how and when it last tested the market by reference to at least one representative example, which should limit the collation effort required by the regulated supplier.
- 5.47 In response to concerns around compliance costs arising from our draft decision, we have removed the requirement to provide a representative example for each opex and capex category. Instead we are requiring a representative example for each method of market testing.¹²⁴

¹²² ERANZ "Related party transactions – Invitation to contribute to problem definition" (17 May 2017), para 4.6.

¹²³ As submitted by Vector "Submission on related party transactions invitation to contribute to problem definition" (17 May 2017), para 10.

¹²⁴ *Electricity Distribution Information Disclosure Amendments Determination 2017* [2017] NZCC 33, clause 2.3.12(4); *Gas Distribution Information Disclosure Amendments Determination (No.2) 2017* [2017] NZCC

- 5.48 This disclosure is not required where a de minimis threshold is met, as summarised in Table 5.2.

Map of anticipated network expenditure and network constraints

- 5.49 We consider that if a regulated supplier has the potential for undertaking related party transactions in respect of potential projects identified in its AMP, then future opex and capex projects with related parties should be disclosed on a map of anticipated network expenditure and network constraints.
- 5.50 We consider this disclosure requirement has the potential to support suppliers of the regulated service by enabling third party providers to suggest cost-effective (and potentially non-network) solutions. This disclosure requirement is intended to provide confidence that input costs of the regulated service are efficient.¹²⁵
- 5.51 With new technology developments happening rapidly in the energy distribution sectors, an easily accessible disclosure of network projects and network constraints would also enable the supplier of the regulated service to identify potential alternative solutions.
- 5.52 Similar disclosures are provided in most AMPs. However, we consider that an additional simplified high level summary of such information, particularly where related parties have been or may be engaged to carry out the work, would better enable interested persons to quickly identify potential opportunities to offer new services. If that provision is more efficient, consumers could benefit.

34, clause 2.3.12(4); and *Gas Transmission Information Disclosure Amendments Determination (No.2) 2017* [2017] NZCC 35, clause 2.3.12(4).

¹²⁵ That is, the price charged to consumers is based on efficient input costs and the presence of related party transactions does not result in inflated prices to consumers. This is outlined further in Table 2.1 of this paper.

5.53 Submissions on our draft decision considered that a map of anticipated network expenditure and network constraints, as described above, was not solely a related parties issue, and that therefore, the imposition of any such disclosure requirements was not within the permissible scope of our problem definition. For example, PwC commented that:¹²⁶

The proposal to require asset management information about network constraints and future network investment is not necessary to provide transparency about related party transactions. This is a wider asset management issue which is not confined to those with related party service providers. These additional disclosures should not be included in this decision because they fall outside the scope of the problem being addressed.

5.54 We accept that this requirement could be seen as a wider asset management issue and therefore could be extended to apply to all regulated suppliers, regardless of whether they transact with related parties. We also acknowledge that it may have been possible to interpret our draft decision as being aimed at the disclosure of information that is related to regulated suppliers more generally. More specifically, our draft decision required the disclosure of information if the regulated supplier had any related parties, but the information required to be disclosed itself did not specifically relate to related parties.

5.55 The final ID amendments determination requires regulated suppliers to disclose, for each item of future opex or capex required to be included on the map, whether the future opex or capex is:

5.55.1 already contracted with a supplier and, if so, whether it is with a related party;

5.55.2 forecast to require the supply of assets, goods or services by a related party; or

5.55.3 currently not projected for supply by a related party.

¹²⁶ PwC "Submission to the Commerce Commission on Input methodologies review: draft decision on related party transactions" (27 September 2017), para 13.

- 5.56 We note that Energy Networks Australia has developed a network opportunities map to provide transparent and up-to-date information that can address network capacity constraints and reduce costs to consumers.¹²⁷
- 5.57 This disclosure is not required where a de minimis threshold is met, as summarised in Table 5.2.

Related party loan disclosures

- 5.58 In response to our draft decision, Vector submitted that the Commission should consider inter-company loan disclosure as part of the related party rules:¹²⁸

If the Commission is minded to consider amendments to the RPT rules based on deriving a public benefit irrespective of whether the benefit is related to the Part 4 purpose, then it should consider creating greater transparency around related party inter-company loans. We believe there is a public benefit from having greater transparency around related party inter-company loans among suppliers.

- 5.59 The current Part 4 regime assumes a fixed notional level of leverage of 42% for EDBs and gas pipeline businesses, and the ID requirements do not require disclosures of loans to or by companies regulated under Part 4. This is irrespective of whether the loans are to or from related party providers or arms-length providers.
- 5.60 We acknowledge there are potential risks to consumers if regulated suppliers use excess levels of debt to fund their investments in opex or capex, as this could constrain the suppliers' ability to invest efficiently in their networks. However, it is not evident why we should single out related party loans for disclosure as opposed to requiring more general disclosure of the ability of suppliers to invest in their networks, including their debt levels. Therefore, we have not extended the disclosure requirements to cover inter-company or other lending to or from related parties.

¹²⁷ The map and subsequent information on the opportunities map can be found at: <http://www.energynetworks.com.au/network-opportunity-maps>.

¹²⁸ Vector "Vector submission on the Review Related Party Transactions Review Draft Decision" (27 September 2017), paras 36–37.

Attachment A Guidance for the interpretation of paragraphs (a) and (b) of the ‘related party’ definition

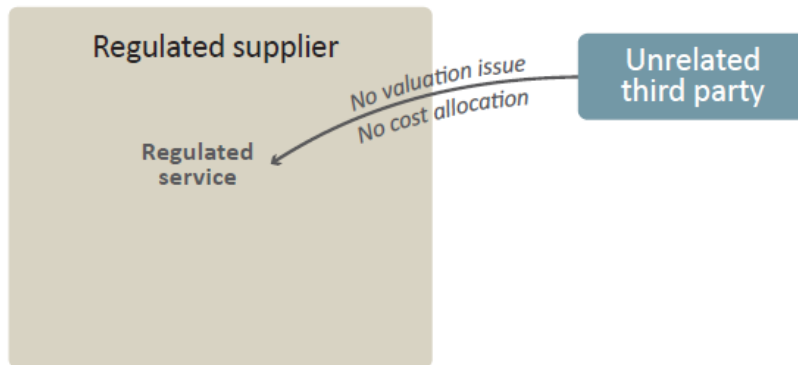
Purpose of this attachment

- A1 This attachment is intended to provide guidance to suppliers and other stakeholders on the interpretation of the two paragraphs of the ‘related party’ definition.
- A2 Figure A1 outlines scenarios where the related party rules and cost allocation rules could apply. In these examples the scenarios refer to a regulated supplier and the regulated service that it provides. The scenarios are:
- A2.1 *No related party valuation/No cost allocation:* no related party is used by the regulated supplier to supply services, goods or assets to the regulated service and all transaction costs charged from the unrelated third party to the regulated service are identified as being directly attributable to the regulated service. All charges from the unrelated third party are disclosed at cost and the regulated supplier derives no margin on those costs other than in the regulated service.
- A2.2 *No related party valuation/Cost allocation applies:* no related party is used by the regulated supplier to supply services, goods or assets to the regulated service, and the transaction costs charged from the unrelated third party apply to both the regulated service and unregulated services provided by the regulated supplier. All charges from the unrelated third party to the regulated service are disclosed at cost and the regulated supplier derives no margin on those costs other than in the regulated service.
- A2.3 *Related party valuation paragraph (a) applies/No cost allocation:* services, goods or assets are provided to the regulated service by both a related party company (ie, paragraph (a) applies) and by an unrelated third party. All transaction costs charged from the related party company and the unrelated third party to the regulated service are identified as being directly attributable to the regulated service.
- A2.4 *Related party valuation paragraph (a) applies/Cost allocation applies:* services, goods or assets are provided to the regulated service by both a related party company (ie, paragraph (a) applies) and by an unrelated third party. The transaction costs charged from the related party company and the unrelated third party apply to both the regulated service and unregulated services provided by the regulated supplier.

- A2.5 *Related party valuation paragraph (b) applies/No cost allocation:* services, goods or assets are provided to the regulated service by both a related party part of the regulated supplier (ie, paragraph (b) applies) and by an unrelated third party. The related party part also supplies services, goods or assets to unrelated external parties. All transaction costs charged from the related party part and the unrelated third party to the regulated service are identified as being directly attributable to the regulated service.
- A2.6 *Related party valuation paragraph (b) applies/Cost allocation applies:* services, goods or assets are provided to the regulated supplier by both a related party part of the regulated supplier (ie, paragraph (b) applies) and by an unrelated third party. The related party part also supplies services, goods or assets to unrelated external parties. The transaction costs charged from the related party part and the unrelated third party apply to both the regulated service and unregulated services provided by the regulated supplier.

Figure A1: Related party rules and cost allocation scenarios

1. No valuation issue/No cost allocation



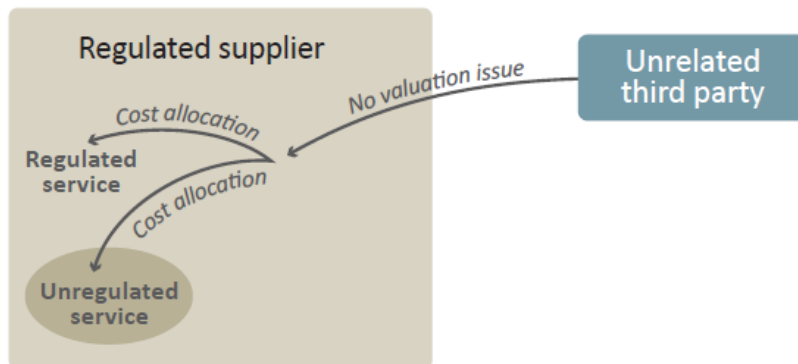
Facts:

- All costs are incurred from external third parties
- All costs are directly attributable to the regulated service

Key features:

- No 'related party' of the regulated service
- No valuation issue on third party costs (meets arm's-length test)
- No cost allocation applies (no cost directly attributable to an unregulated service and no cost needs to be allocated between regulated service and unregulated services)

2. Cost allocation only – no valuation issue



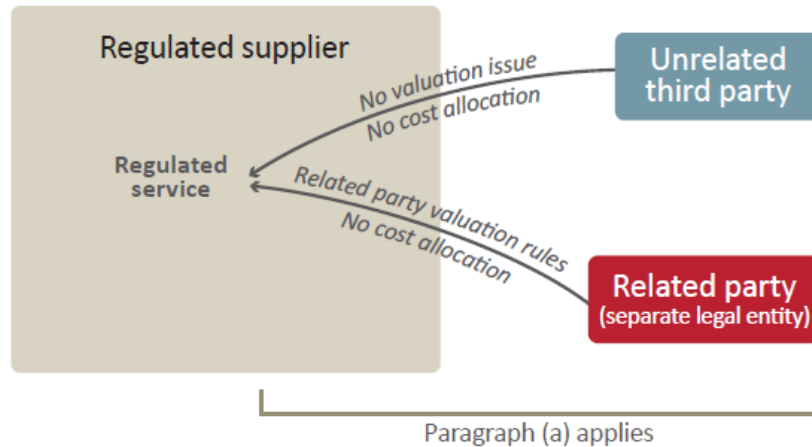
Facts:

- All costs are incurred from external third parties
- Costs apply to regulated service and unregulated services
- No services supplied by unregulated service to regulated service

Key features:

- No 'related party' of the regulated service
- No valuation issue on third party costs (meets arm's length test)
- Costs directly attributable to regulated service are allocated under cost allocation rules to the regulated service
- Costs not directly attributable to regulated service or unregulated service; use cost allocation to allocate between regulated and unregulated services

3. Paragraph (a) of related party definition applies – no cost allocation



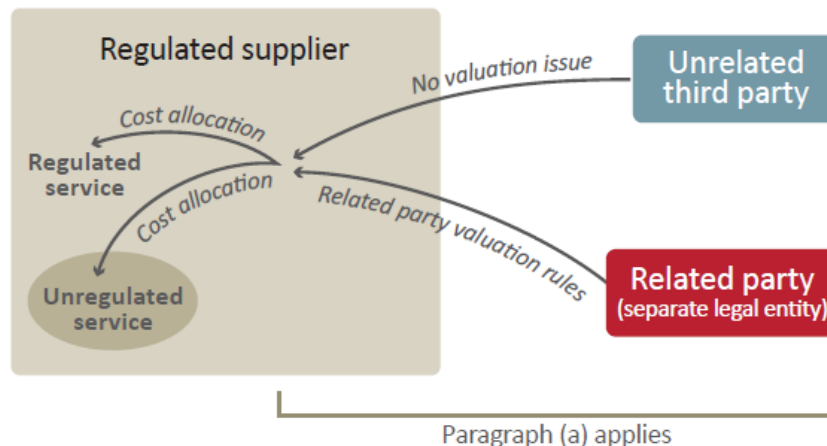
Facts:

- One related party (separate legal entity) supplying the regulated supplier
- Also some costs from external third parties
- All costs are directly attributable to the regulated service

Key features:

- No valuation issue on third party costs (meets arm's-length test)
- Valuation of charges from related party – related party valuation rules apply
- No cost allocation applies (no cost directly attributable to an unregulated service and no cost needs to be allocated between regulated and unregulated services)

4. Paragraph (a) of related party definition applies with cost allocation



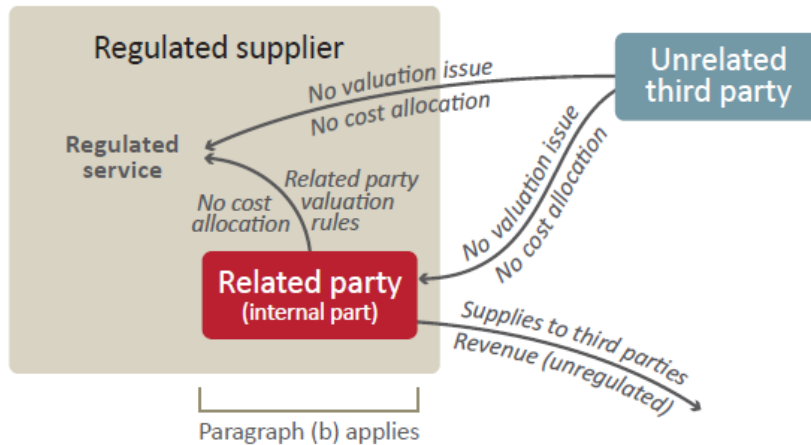
Facts:

- One related party (separate legal entity) supplying the regulated supplier
- Also some costs from external third parties
- Costs apply to regulated service and unregulated services

Key features:

- No valuation issue on third party costs (meets arm's-length test)
- Valuation of charges from related party – related party valuation rules apply
- Costs directly attributable to the regulated service are allocated under cost allocation rules to the regulated service
- Costs not directly attributable to the regulated service or unregulated service; use cost allocation to allocate between regulated and unregulated services

5. Paragraph (b) of related party definition applies – no cost allocation



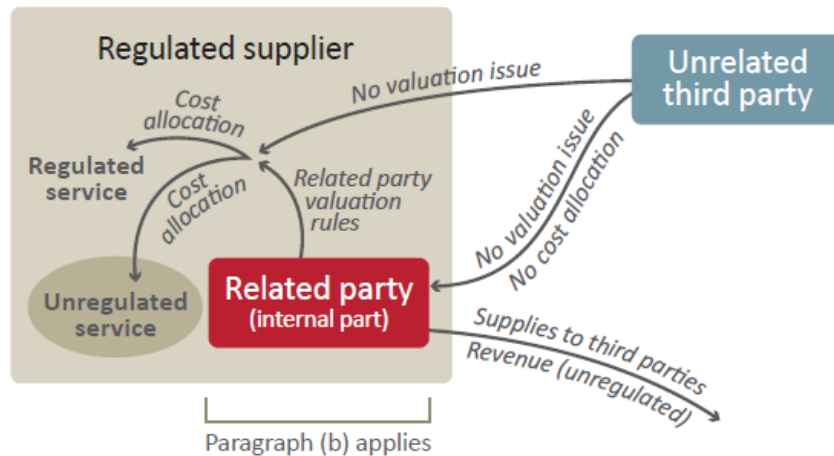
Facts:

- An internal part of the regulated supplier supplies to the regulated service and sells assets, goods or services externally
- The internal part of the regulated supplier has the management and operational features of a business capable of standing alone
- Some costs are incurred by the regulated service directly from external third parties
- Some costs are incurred from external third parties through the internal related party
- All costs directly incurred by the regulated service from third parties are directly attributable to the regulated service
- All charges from the internal related party to the regulated service are directly attributable to the regulated service

Key features:

- No valuation issue on third party costs when passed directly to the regulated service at cost with no additional margin (meets arm's-length test)
- Valuation of charges from internal related party – related party valuation rules apply
- No cost allocation applies to charges from unrelated third party directly to the regulated service
- No cost allocation applies to charges from internal related party to the regulated service
- No requirement to apply cost allocation or related party valuation rules to charges from unrelated third party to unregulated internal related party

6. Paragraph (b) of related party definition applies with cost allocation



Facts:

- An internal part of the regulated supplier supplies to the regulated service and sells assets, goods or services externally
- The internal part of the regulated supplier has the management and operational features of a business capable of standing alone
- Some costs are incurred by the regulated service directly from external third parties
- Some costs are incurred from external third parties through the internal related party
- Costs apply to regulated service and unregulated services

Key features:

- No valuation issue on third party costs when passed directly to the regulated service at cost with no additional margin (meets arm's-length test)
- Valuation of charges from internal related party – related party valuation rules apply
- Costs directly attributable to the regulated service or unregulated service; are allocated to the regulated service
- Costs not directly attributable to the regulated service use cost allocation to allocate between regulated and unregulated services
- No requirements to apply cost allocation or related party valuation rules to charges from unrelated third party to unregulated internal third party

Attachment B Indicative examples of arm's-length and non-arm's-length transactions

Purpose of this attachment

- B1 This attachment is intended to provide guidance to suppliers and other stakeholders on how a related party transaction may (or may not) meet the general valuation rule.
- B2 This is not intended to replace the valuation methodology, and is only intended to support the application of the general valuation rule in the body of the IM and ID determinations.¹²⁹

¹²⁹ See: *Electricity Distribution Services Input Methodologies Amendments Determination 2017* [2017] NZCC 30, clauses 2.2.11(1)(g), 2.2.11(5), 5.3.11(1)(g) and 5.3.11(7); *Gas Distribution Services Input Methodologies Amendments Determination 2017* [2017] NZCC 31, clauses 2.2.11(1)(g), 2.2.11(5), 5.3.11(1)(g) and 5.3.11(7); *Gas Transmission Services Input Methodologies Amendments Determination 2017* [2017] NZCC 32, clauses 2.2.11(1)(g), 2.2.11(5), 5.3.11(1)(g) and 5.3.11(7); *Electricity Distribution Information Disclosure Amendments Determination 2017* [2017] NZCC 33, clause 2.3.6; *Gas Distribution Information Disclosure Amendments Determination (No.2) 2017* [2017] NZCC 34, clause 2.3.6; and *Gas Transmission Information Disclosure Amendments Determination (No.2) 2017* [2017] NZCC 35, clause 2.3.6.

Examples of related party transactions which would and would not be considered on arm's-length terms

B3 Table B1 provides a list of indicative transactions on arm's-length terms to support regulated suppliers with their understanding of the valuation methodology.

Table B1 Non-exhaustive list of examples of arm's-length transactions

Method	Brief description
Open tendering process	Regulated supplier follows an open tendering process with the following indicative attributes to determine the arm's-length terms: <ol style="list-style-type: none"> i. all relevant terms are accessible by third parties prior to providing a tender; ii. the regulated supplier assesses all tenders which are equally the most advantageous to the supplier of the regulated service; and iii. in considering the term of the contracts of services, the regulated supplier considers the industry best practice for that service and the materiality of the service.
Comparable pricing	Regulated supplier uses comparable pricing with the following indicative attributes to determine the arm's-length terms when majority of its related party's sales are to third parties: <ol style="list-style-type: none"> i. third parties may purchase the same or substantially similar assets from the related party on substantially the same terms, including price; or ii. over time that price is substantially the same as the price paid for substantially similar assets or services from a party other than a related party.
Independent market valuation	Recorded at its market value as at the date of acquisition as determined by an independent valuation.

B4 Table B2 provides a non-exhaustive list of examples of transactions which on their own would not meet the arm's-length requirement or would not demonstrate the valuation is based on an objective and independent measure.

B5 We note that depending on the individual situation, auditors may be able to complete additional testing to verify that such methods meet the requirements of the general valuation rule.

Table B2 Non-exhaustive list of examples of non-arm's-length transactions

Method	Brief description
Internal sign off	Where the director or internal manager of the supplier of the regulated service has verified the transaction as arm's-length without ensuring that there has been consideration for the open market. This would not demonstrate objective and independent measurement.
Long-term contracts with no review period or termination provisions	<p>The supplier of the regulated service enters into long-term contracts with no considered review period. Such transactions could become out of date with current market practices and prices.</p> <p>We note that contracts with longer terms can be important to underpin large investments by suppliers and promote competition. However, the appropriate contract length will depend on the type of asset or service being provided.</p>
No documented procurement policy in place	Without a clear procurement policy, on its own, it may be more difficult for the auditor to assess that the arm's-length principle would be met.

Indicative worked examples

B6 The following are indicative worked examples which show how related party transactions could meet the general valuation rule:

- B6.1 The Big City Lines Limited (**BCLL**) situation, where there is clear opportunity to benchmark against an existing arm's-length contractor.
- B6.2 The Regional Lines division situation, where there is an imperfect regional market for contracting services and a greater depth of audit scrutiny might be expected.

Example 1: Big City Lines Limited's situation

- B7 BCLL provides electricity lines services to a large region of 250,000 consumers and owns related party Big City Vegetation Limited, which provides vegetation management services to BCLL.
- B8 BCLL requires \$150,000 of vegetation management work over the next year and would like Big City Vegetation Limited to undertake most of the work.
- B9 For vegetation management services, approximately 60% of this work is completed by Big City Vegetation Limited. The remainder is completed by an independent third party contractor that operates in the region. BCLL is able to observe the third party contracting price so can benchmark procurements from the related party against this price.

- B10 The independent auditor must assess whether BCLL is able to demonstrate compliance with the general valuation rule. The auditor is able to cite sufficient evidence to test that BCLL procures the services from Big City Vegetation Limited at terms consistent with those provided by the other third party contractor. On that basis, the auditor is likely to have enough information to be able to form the assurance opinion.

Example 2: Regional Lines' division situation

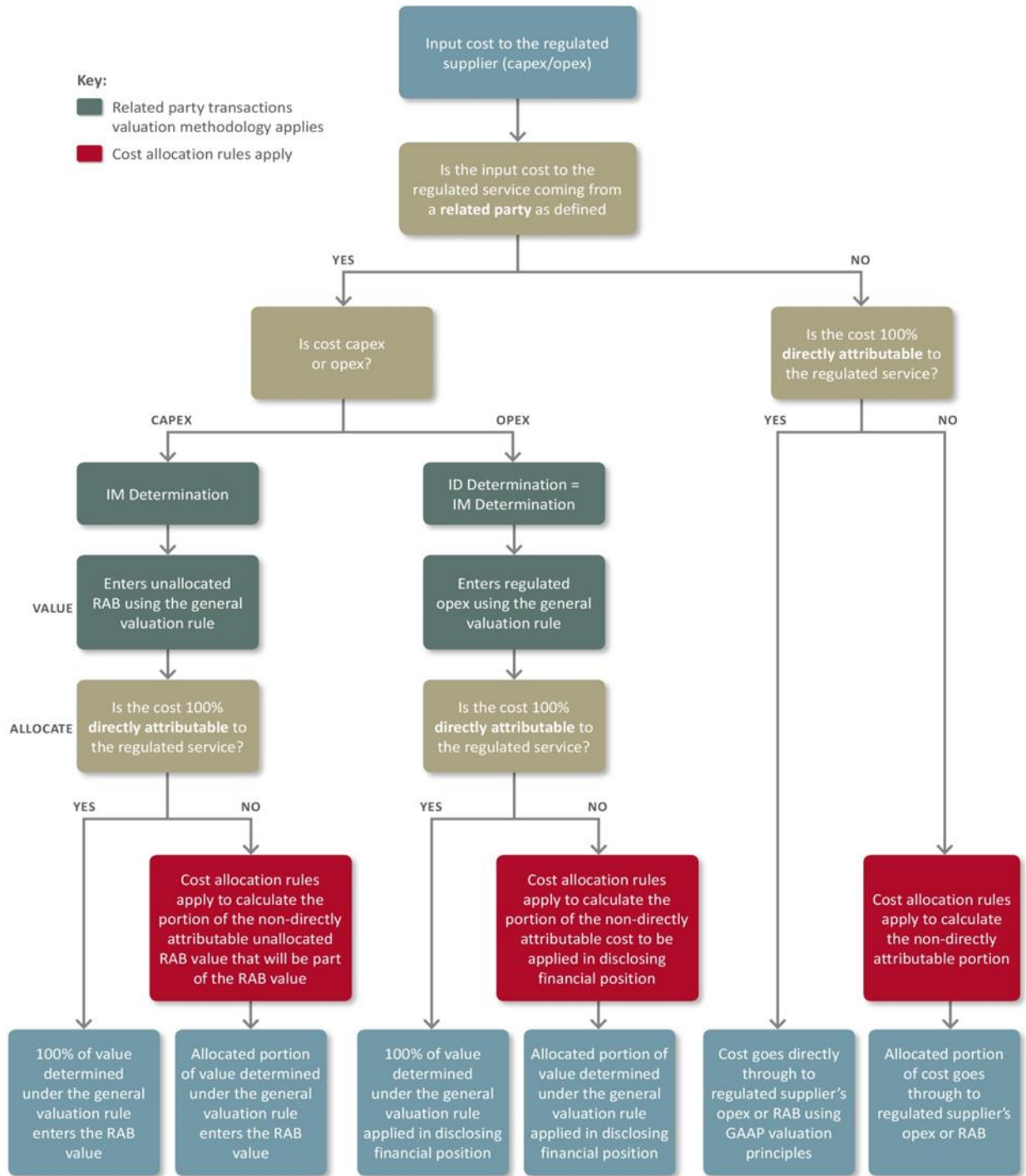
- B11 Regional Lines provides electricity lines services to a regional town of 40,000 consumers and operates related party Regional Lines Engineering, which is a division of Regional Lines. Regional Lines Engineering provides electrical engineering services for Regional Lines' lines service and other EDBs in nearby regions.
- B12 There are currently no other electrical engineering providers in the region of sufficient scale to carry out the work that Regional Lines requires.
- B13 Regional Lines requires electrical engineering services, and has engaged its division Regional Lines Engineering to complete the work.
- B14 Regional Lines uses an external consultancy company to complete benchmarking services to determine the permissible price that can be charged to Regional Lines Engineering for electrical engineering services. As Regional Lines Engineering is the only available electrical engineering service provider in the region capable of carrying out the work, Regional Lines compares the prices charged by Regional Lines Engineering with the benchmarking completed by the external consultancy.
- B15 The independent auditor must assess whether Regional Lines is able to demonstrate compliance with the general valuation rule. The auditor is able to cite sufficient evidence to test that Regional Lines procures the services from Regional Lines Contracting at terms consistent with those provided by the external consultancy company. On that basis, the auditor is likely to have enough information to be able to form the assurance opinion.

Attachment C Relationship between cost allocation rules and the related party transactions provisions

Purpose of this attachment

- C1 This attachment provides guidance on how the amended related party transactions rules work with the cost allocation rules under common input cost scenarios. This guidance does not form part of the ID determination and is provided to help with application of the ID requirements.

Figure C1: Related Party transactions and cost allocation



Attachment D Incorporation of auditing and accounting standards by reference into determinations

Purpose of this attachment

- D1 This attachment provides an overview of how we have incorporated relevant auditing and accounting standards into the IM and ID determinations by reference in accordance with the applicable drafting rules set out in Schedule 5 of the Act.

Incorporation by reference process

- D2 To provide greater alignment and minimise interpretation issues, we have incorporated relevant auditing and accounting standards into the IM and ID determinations.
- D3 We have incorporated *International Standard on Assurance Engagements (New Zealand) 3000, Assurance Engagements Other than Audits or Reviews of Historical Financial Information, Standard on Assurance Engagements 3100 – Compliance Engagements* into the relevant ID Determinations and part of the definition of ‘related party’ from *New Zealand Equivalent to International Accounting Standard 24, Related Party Disclosures (NZ IAS 24)* (auditing and accounting standards) into the relevant IM Determinations by reference in accordance with the process set out in Schedule 5 of the Act in order to provide:
- D3.1 greater clarity around the requirements for the review of related party transactions in the ID independent audit assurance engagement; and
 - D3.2 greater consistency between our determinations and the auditing and accounting standards.
- D4 In our draft decision, we proposed the incorporation by reference of *International Standard on Auditing (New Zealand) 550, Related Parties*, as well as a number of other standards. However, our final decision is to only incorporate by reference the standards listed above, as a result of a submission on our proposed incorporation by reference in our draft decision.¹³⁰

¹³⁰ PwC in capacity as auditors “Submission to the Commerce Commission on Input methodologies review: draft decision on related party transactions” (27 September 2017), paras 24-30.

- D5 Schedule 5 of the Act sets out the process for incorporating material by reference into a determination made under s 52P or into an input methodology made under s 52W. We have incorporated material by reference into:
- D5.1 the ID determinations;¹³¹ and
 - D5.2 the IM determinations.¹³²
- D6 The Act allows us to incorporate material by reference into a determination or input methodology if:
- D6.1 the material deals with technical matters; and
 - D6.2 it is impractical to include it in or publish it as part of, the determination or input methodology.¹³³
- D7 We consider that the auditing and accounting standards are technical in nature because they deal with technical accounting and auditing matters. We also consider that it would be impractical to include the auditing or accounting standards in the determinations themselves due to the length of the auditing and accounting standards.
- D8 The auditing and accounting standards must be incorporated into the determinations as they exist at the time the determinations are published and have legal effect as part of the determinations.¹³⁴
- D9 Accordingly, we have incorporated the following standards into the ID Determinations:
- D9.1 *International Standard on Assurance Engagements (New Zealand) 3000, Assurance Engagements Other than Audits or Reviews of Historical Financial Information*, issued by the New Zealand Auditing and Assurance Standards Board of the External Reporting Board in July 2014; and
 - D9.2 *Standard on Assurance Engagements 3100 – Compliance Engagements* issued by the External Reporting Board in October 2014 and incorporating amendments up to August 2014.
- D10 We have also incorporated part of the definition of ‘related party’ from *New Zealand Equivalent to International Accounting Standard 24, Related Party Disclosures (NZ IAS 24)* issued by the New Zealand Accounting Standards Board of the External

¹³¹ Made under s 52P of the Act.

¹³² Made under s 52Y of the Act.

¹³³ Clause 2 of Schedule 5 to the Act.

¹³⁴ Clause 2(3) of Schedule 5 of the Act.

Reporting Board in November 2009, incorporating amendments to 31 December 2015 into the IM Determinations.

- D11 Later amendments to or replacements of the auditing and accounting standards are not automatically incorporated into, and have legal effect as part of, the determinations. This will only occur if a subsequent determination or input methodology states that the amendment or replacement has legal effect as part of the determination or input methodology, or the Chairperson of the Commission adopts the amendment or replacement as having legal effect by notice in the Gazette.¹³⁵
- D12 The amendment or replacement must also be made by the person or organisation that made the original material and must be of the same general character as the original material.
- D13 Our intention is to adopt any amendments or replacements to the auditing and accounting standards to the extent they are consistent with our related party provisions policy intent and have legal effect as part of the determinations. This will ensure that the requirements in our determinations reflect the most up-to-date auditing and accounting standards.

¹³⁵ Clause 5 of Schedule 5 of the Act.